



Behavioural economics and the regulation of consumer credit

Published with the assistance of the New Zealand Law Foundation

Dr Richard Tooth

August 2012

Behavioural economics and the regulation of consumer credit¹

Published with the assistance of the New Zealand Law Foundation

Richard Tooth
August 2012

¹ This paper has benefited from comments from Glenn Boyle, Simon Kemp, Tim Irwin, Sally Wyatt and two anonymous reviewers, none of whom should be presumed to agree with its conclusions.

Introduction

1. Recently, renewed concerns have been raised that many New Zealanders borrow too much or borrow on bad terms because they have difficulty making good decisions about credit and because lenders exploit those difficulties (Anae et al. 2007; Families Commission 2009; Legge and Heynes 2008; Ministry of Consumer Affairs 2009).

2. Although consumer credit in New Zealand is already regulated, there are calls for more and better regulation to protect consumers. The purpose of this paper is to use a case study to examine the consumer credit market through the lens of behavioural economics. This paper supplements a ‘companion paper’ titled *‘Implications of behavioural economics for regulatory reform in New Zealand’*.

3. Behavioural research offers the prospect of moving beyond focussing on poor outcomes and focussing more on where and why consumers make poor choices. This case study considers whether behavioural economics sheds light on the nature of consumer issues with the consumer credit market and how regulation might be used to address these issues. In doing so, it aims to illustrate the advantages, and the pitfalls, of applying behavioural economics to questions of regulatory reform.

4. Consumer credit is a useful industry to examine behavioural economics. Consumer credit, like many other financial services, involves consumers analysing complex information, making choices over time and assessing risks — all factors which have been the focus of behavioural economics research. It is thus not surprising that the consumer credit industry has attracted a great deal of attention from behavioural economists.

5. The rest of this paper is structured as follows. The next section provides some background on the consumer credit industry and its regulation. The following section examines consumer behaviour issues of relevance to the consumer credit industry. This is followed by a review of regulations (existing and proposed) that might be used to address consumer behaviour issues. The paper ends with discussion about the regulatory process and some conclusions from the case study.

Consumer credit and its regulation

Background to the consumer credit industry

6. ‘Consumer credit’ generally refers to the supply of credit for which interest or a fee is payable. Consumer credit contracts incorporate a broad range of financial products that enable individuals to borrow to meet their immediate needs

including credit cards, personal loans, vehicle financing, hire purchase agreements, student loans and mortgages. In addition, there are other products such as leases of goods that share similar characteristics and are often considered by policy makers in conjunction with consumer credit products.

7. Consumer credit has a number of features that distinguish it from other consumer products. Consumer credit products are not tangible products for sale but rather a contract for service. The total cost of a consumer credit contract is generally not fixed but rather accumulates over time as determined by the interest rate charged. Unlike other contracts (including other financial contracts such as investments), consumer credit contracts require the product provider to obtain information from the consumer to assess the consumer's credit worthiness.

8. The nature of the consumer credit industry has changed dramatically in New Zealand and internationally in recent times. Advances in financial risk management and an explosion in the number of credit products offered to the market have resulted in similarly large increases in levels of debt held by individuals and households. The nature of credit products has changed too. In the last three decades, credit cards have risen from being a minor source of credit to become the most common form of borrowing.

9. The context for consumer credit has also changed. It is only in the late twentieth century that, fuelled by the increasing life expectancy and a shift towards individual saving, retirement planning has become a significant issue for consumers and governments. Now, more than ever before, consumers need to make choices between spending today and saving for the future.

10. There are many providers of consumer credit ranging from mainstream banks to small fringe lenders. The market for consumer credit in developed countries is generally regarded as competitive, as it tends to have many suppliers and few barriers to entry.² It appears that lenders in New Zealand compete aggressively (at least in terms of sales and marketing) to attract new consumers and to entice customers to switch from other lenders.

Regulation of consumer credit

11. Consumer credit has been regulated for millennia; at times, the practice of charging interest has been banned altogether; at other times, interest rate ceilings have been set; occasionally, as in Britain in 1854–1900, it has been deregulated (Birkinshaw 2005).

12. There is also a long history of debates by economists as to how consumer credit should be regulated. For example, Adam Smith (1776) worried about

² For example, Cagney and Cossar (2006) identified 185 fringe lending companies in New Zealand and 71 in Auckland.

imperfect rationality and, specifically, about borrowing by ‘prodigals and projectors’, while Jeremy Bentham (1787) defended deregulation arguing that usury laws were both unnecessary and harmful.

13. In New Zealand, credit regulation began with *the Money Lenders Act 1901*, which was subsequently amended in 1933 to require disclosure of certain information by lenders. The US *Truth in Lending Act 1968* ushered in a new era of consumer credit regulation around the world. It required clear and consistent disclosure of interest rates and interest costs before a consumer could enter into any type of credit contract. New Zealand followed suit with the *Credit Contracts Act 1981*.

14. New Zealand’s current regulation of consumer borrowing comes mainly, though not exclusively, from the *Credit Contracts and Consumer Finance Act 2003* (CCCFA). The purposes of the CCCFA include:

- to protect the interests of consumers
- to provide for the disclosure of adequate information to consumers
- to enable consumers to seek reasonable changes to consumer credit contracts on the grounds of unforeseen hardship, and
- to actively discourage oppressive conduct and contracts.

The CCCFA provisions include disclosure requirements, a cooling off period for consumers, and a requirement that non-interest fees be no greater than costs.

15. At the time of writing, the Ministry of Consumer Affairs (MCA) is undertaking a review of New Zealand’s consumer credit regime. A Credit Contracts and Consumer Finance (CCCF) Amendment Bill Exposure Draft has been released and submissions have been received, which are being reviewed. A package of consumer credit law reforms is included, most notably the introduction of responsible lending requirements for consumer credit providers and the strengthening of disclosure requirements.

16. There is also continued interest in other jurisdictions to further consumer credit regulation. This interest has, in part, been fuelled by the recent global financial crisis. In Australia, the *National Consumer Credit Protection Act 2009* was recently enacted, placing greater onus on responsible lending. The United States recently passed the *Dodd-Frank Wall Street Reform and Consumer Protection Act* creating a new Consumer Financial Protection Bureau with powers to write consumer-protection rules for banks and other firms that offer financial services or products.

Consumer issues in the consumer credit industry

Overview

17. This section looks at the extent to which there is a problem in the consumer credit industry of relevance to behavioural economics. Given the focus on behavioural economics, the scope of the discussion is on issues associated with consumer behaviour — that is, the decisions consumers make and the process that they undertake to make those decisions.

18. There are a number of symptoms that suggest there are problems with consumer behaviour towards consumer credit. A large number of New Zealand families appear to live under significant financial strain due to over-indebtedness. As reported by Legge (2009), in 2004 around 16 per cent of families were experiencing financial strain and were in a situation of negative equity.³ There are also indicators that many consumers have concerns with the current consumer credit industry. Buzz Research (2008) found that around 30 per cent of those surveyed had a problem with debt or the use of their credit card. They also noted that '[m]any respondents found that debt was just too easy to acquire, and are now in trouble because of it'. Of interest for policy makers is the finding that almost half of the respondents thought there should be changes to the laws governing credit cards.

19. However, it is difficult to assess whether problems exist without examining individual circumstances. There are a number of challenges. While people may have regrets with regard to their consumer credit decisions, it is not clear whether these decisions necessarily reflect poor choices. As with any product that involves an assessment of risk, it is inherently difficult to assess whether poor choices are made given they were made without the benefit of hindsight. That a consumer finds him or herself indebted does not necessarily reflect a poor decision — it may simply reflect an unfortunate set of circumstances. Poor choices need to be assessed in the circumstances in which they were made — that is without the benefit of hindsight and detailed industry knowledge of the researcher.

20. Another challenge is that decisions are often made with limited information. As with other industries, consumers may make seemingly poor and ill-informed choices because the cost of acquiring and processing additional information to make a more considered choice outweighs the potential benefits.

21. Given these challenges it is very difficult to gather direct empirical evidence on poor consumer decisions. As such, it is useful to draw on theories of

³ The study was based on the Ministry of Social Development's Living Standards Survey 2004. Of note, around a quarter of households reported living under financial strain.

consumer behaviour and on empirical findings of consumer behaviour in other settings.

22. This following text examines a neoclassical economic analysis of consumer behaviour and issues.⁴ A neoclassical economic analysis is important in helping to explain consumer behaviour, so provides a useful starting point before turning to behavioural economics. Furthermore, a potential benefit of behavioural economic analysis is in developing regulation that may address other policy goals that may be identified through a neoclassical analysis. For example, the findings of behavioural economics may be used in developing policies to support other policy goals regarding consumer saving.

Neoclassical economic analysis of consumer credit

23. Before examining the extent to which there are consumer behavioural biases, it is useful to reflect on concerns that stem from neoclassical analysis of consumer credit. Two main consumer issues — relating to consumer spending and saving and the search costs for consumers — are discussed below.

24. It is also worth noting that there are other potential market failures with the consumer credit industry that are not related to consumer behaviour. For example, some commentators have questioned whether the consumer credit industry is sufficiently competitive, leading to a concern that consumers pay more for credit than they should.⁵ Another potential concern is that because lenders are unable to distinguish between low and high default-risk borrowers they are unable to price differentiate between the two. In this case, a problem of adverse selection could evolve whereby low-default-risk borrowers view the borrowing costs as excessive and are discouraged from borrowing. This in turn leads to a bias towards borrowing by high-default-risk borrowers. As a result, market outcomes may be inefficient, even if there is strong competition (Stiglitz and Weiss 1981). Regulation to address a problem of adverse selection (e.g. through standards to reduce the cost of collecting credit information) could be desirable⁶ but it

⁴ As discussed in the companion paper, by ‘neoclassical’ economic analysis we refer to the assumptions of rationality and self-interest but relax the assumption of perfect information.

⁵ Some have argued that the industry is not competitive. For example, Ausubel (1991) argues that there is imperfect competition in the credit market that has resulted in excess profits. He estimated that during the 1980s bank credit card operations earned several times the rate of return of other banking operations. His claim is based on the combination of: high consumer search costs, high consumer switching costs and the adverse selection risk. Massoud et al. (2006) find that the incidence of some credit card fees are correlated with bank market share, suggesting that larger banks are able to maintain above-normal margins. However, other explanations are possible — for example, the results suggesting excessive profits or margins, could reflect the investment over a long period of time by banks in marketing and brand development.

wouldn't be traditional consumer protection and it is not closely related to the scope of this study.

Consumer spending and saving

25. Concerns are often expressed about the effects of consumer borrowing on long-term saving. The debt of the average New Zealand household rose from about 50 per cent of disposable income in the mid-1980s to more than 150 per cent in the late 2000s.⁷ One concern about this high level of household debt (or equally, low levels of household savings) is that it may lead to insufficient saving for retirement and increased reliance on Government support. Macroeconomists also worry that insufficient net private saving (the difference between savings and borrowing), may raise the cost of investment, and that excessive borrowing may fuel asset-price bubbles (Orr 2006; Reserve Bank generally; Akerlof and Shiller 2009).

26. It is however, difficult to assess whether saving rates are too low, as it is unclear what an optimal level of saving is. There are standard economic rationales that have been put forward to explain low savings levels. Perhaps the most pertinent relates to a problem of government social policy distorting consumer decisions. In New Zealand, as in other developed countries, there are social security protections for those who have not adequately saved for retirement and emergencies which may discourage private saving. This is however likely to be much less of an issue in New Zealand where, unlike many countries, the main superannuation scheme is not means-tested.⁸

27. Such concerns have led to Government responses to ensure people have sufficient funds for retirement. In general, Government responses have been to attempt to encourage saving (e.g. KiwiSaver) rather than discourage spending. This approach may reflect the concern that efforts to curb spending in the short term could have negative consequences on the economy (Evans and Wright 2010).

⁶ In this regard, New Zealand law was recently changed (as of 1 April 2012) to enable a "positive" (or comprehensive) credit reporting system to operate whereby credit reporters will be able to collect repayment history information. This approach contrasts to a "negative" (limited) system that was in place which just recorded defaults, bankruptcies and court judgments.

⁷ See (Hull 2003). Household debt information is available from the Reserve Bank of New Zealand (<http://www.rbnz.govt.nz/statistics/>).

⁸ Problems of overspending may be related to moral hazard issues around bankruptcy. For example, Zywicki (2008) argues that in the US tightening of the costs of bankruptcy would lead to reduced use of credit cards as people strategically use their credit cards to purchase additional goods in anticipation of bankruptcy.

28. Regardless, standard economic analysis suggests that under-saving (or over-spending) is not caused by consumer access to credit but rather that excessive use of consumer credit is a result of consumer spending behaviour.

Consumer search costs

29. As with other industries consumers face costs in searching to identify and choose the best consumer credit products. Given the cost associated with searching and processing information, people will inevitably make choices that, with the benefit of better information, they regret. A common concern with consumer credit is that consumers face very high search costs due to the complexity of the product and because with consumer credit — as with many other financial services — there is little opportunity to learn from one's own mistakes and learn from others.

30. The presence of high search costs in any market will lead to inefficient outcomes. The search cost problem has often been raised in the context of consumer credit (Ausubel 1991; Carlin 2009). There is a significant amount of evidence that consumers have difficulty in evaluating the difference between alternative products (e.g. Woodward 2003) and, as discussed further below, consumer difficulties in evaluating products have been a key rationale for improved product disclosure. A further concern is that firms have an incentive to increase complexity of the products offered to increase search costs and increase the likelihood that excess margins can be made (Carlin 2009).

31. Reforms that reduce search costs could be welfare enhancing. For example, rules requiring clear and comparable disclosure of loan terms and conditions might be justified to reduce search costs (Schwartz and Wilde 1979).

32. A potential issue arising from disclosure rules in the consumer credit market is that if borrowers believe there is little difference between alternatives then they will undertake little effort to search and compare products. As demonstrated by Diamond (1971) this can lead to a paradox, whereby even when search costs are very small and there are many suppliers, competing firms may be able to price like a monopolist and earn excessive margins. Excessive margins and low barriers to entry may in turn lead to excessive entry and monopoly rents wasted on attempts to gain the customers (Stiglitz 1979).

33. This search paradox may continue to exist because consumers perceive the costs of searching to exceed the benefits. Conversely, the problems of the search paradox may disappear when there are additional benefits to searching that exceed the costs. For example, consumers may enjoy 'shopping around' or perceive there are differences in the products that make comparison shopping beneficial. It only requires a portion of consumers to search for the problem to encourage firms to

price at levels consistent with competitive markets (Shwartz and Wilde 1979).⁹ Thus the risk of the search paradox is lower, the easier it is for consumers to search and the greater heterogeneity there is among the products offered.

34. Even though neoclassical economics recognises problems in the consumer credit market as a result of search costs for consumers, information asymmetries and adverse selection risk, many policies that have been implemented or proposed for consumer credit by the government cannot easily be justified on the basis of neoclassical economics. A standard economic analysis may lead to the conclusion that regulation is unwarranted and welfare-reducing.

Behavioural analysis of issues

35. This section considers the behavioural theories and evidence on consumer issues in the consumer credit industry. These are categorised (consistent with the companion paper) into issues around: poor use of information; susceptibility to framing; over-confidence; choices over time; and social preferences.

Poor use of information

36. A common behavioural view is that consumers may make poor decisions with regard to consumer credit because they struggle with the complexity of information. As discussed in the companion paper, faced with complexity, consumers may resort to simple, but potentially biased, decision rules. These decision rules include simply accepting the defaults, basing their choice on some information anchor or using simple rules of thumb.

37. Often making decisions based on simple decision rules is an effective strategy. The common or ‘default’ option is typically the option that appeals to most. The process of competition discourages suppliers from offering poor value products for fear of losing repeat business and potential sales through word of mouth. However, with consumer credit (as with some other financial services), consumers cannot simply rely on default options as they need to make an important individual decision with respect to the level of credit. Furthermore, as consumer credit choices can have long lasting effects, there is little opportunity to learn from one’s own and others’ experience. As such, the risk and significance of poor decisions can be relatively high compared with other goods and services.

38. The implications of difficulty in decision making in consumer credit can be significant. For example, Barr et al. (2008) argue that a central problem with the recent mortgage crisis in the United States ‘was that many borrowers took out loans that they did not understand and could not afford.’

⁹ If a significant enough portion of consumers search, then some firms will benefit by pricing below the monopoly price. This in turn encourages more consumers to search and drives firms to charging a competitive market price (see Schwartz and Wilde 1979 for a more detailed description).

39. A significant concern is consumer bias in using information. With regard to consumer credit, a common finding is that to varying degrees, consumers underestimate the power of compound interest, and thus are likely to save too little and borrow too much (Stango and Zinman 2009) and choose less favourable product options.¹⁰

Susceptibility to framing

40. An implication of consumer difficulties in making complex financial decisions is that they are influenced by the information they receive. This has a number of implications for how consumers respond to marketing and how products are used.

41. As with other goods, potential borrowers may fall prey to superficially appealing but actually unattractive offers (Frederick 2005). For example, consumer ‘interest free’ loans but involving very high application fees. A common perception is that lenders make mistakes because they are misled (for example, Barr et al. (2008) argue that consumers taking out home mortgages were misled by broker sales tactics). There is some direct evidence that borrowers can be influenced. For example, male South African recipients of junk mail offering a short-term loan were found to be much more likely to take up the loan if the letter included a photo of a woman’s face. The photo increased take-up as much as a 4.5 percentage point reduction in the monthly interest rate (Bertrand et al. 2010).

42. A common strategy used by firms is to levy high charges for less salient services and optional extras. For example, if some borrowers ignore the fine print, lenders can profit by setting a low interest rate and levying high charges for prepayments and other optional extras. This pricing strategy is similar to that of hotels that offer cheap rooms but expensive phone calls and mobile phone service providers who offer cheap services but expensive additional services.

43. These extra charges have been described as ‘shrouded attributes’ — product attributes ‘hidden by a firm, even though the attribute could be nearly costlessly revealed’ (Gabaix and Laibson 2005). While shrouding is inefficient, firms may not have an incentive to de-bias (i.e. educate) consumers if consumers can cheaply avoid the extra costs. Rather firms, as Gabaix and Laibson (2005) argue, may be better off by using marketing schemes to exploit consumer focus on the headline price.

44. Consumers may also be influenced by lenders in how they use their consumer credit products. For example, Soman and Cheema (2002) present experimental and survey evidence that some consumers interpret available credit

¹⁰ A 2006 report of New Zealand Financial Knowledge (Colmar Brunton, 2006) concluded that ‘Most of the population do not understand compound interest’.

lines as indications of future earnings potential when deciding consumption expenditures. Similarly, credit cards may lead to overspending because they provide absent-minded consumers with less information on spending flows than cash transactions do (Caplin and Leahy, 2004).¹¹ Credit-card holders' monthly payments are influenced by the required minimum payment stated on the bill, which acts as an anchor (as discussed in the companion paper). If the minimum payment is low, some pay less than they would if there were no minimum (Stewart 2009).

45. While on the surface, it would appear that lenders share an objective with their customers that they do not borrow too much, in general the alignment of interest is not that great. For the lender the biggest risk is that the borrower defaults — a risk that is significantly mitigated when lending is secured, or when the risk is shared with a third party, for example, via a debt security.

46. In contrast, a consumer has potential to suffer greatly as a result of excessive borrowing well before he or she reaches the point of default. A consumer's financial distress may include the sale of assets or use of higher cost debt instruments to meet short term needs. Once reached, financial default can a significant event for a borrower, leading to substantial additional costs (e.g. in moving house), stress, and long term problems in future borrowing. In contrast, financial default for one borrower is seldom as significant for a lender, who has a portfolio of borrowers and is able to spread default risk.

47. A concern is that providers of credit also have a strong interest in how consumers use their product and that this interest is not closely aligned with the interests of the consumer. Once customers have signed up to a credit contract, lenders have strong incentives to encourage greater borrowing. From a survey of New Zealand consumer credit customers, Buzz Research (2008) found that many borrowers received extensions of credit automatically. Around of a third of respondents to the survey who found that cancelling their credit cards involved 'significant difficulties'.

Overconfidence

48. Another reason for poor consumer decisions with regard to consumer credit is that people are overly optimistic and have other biases in assessing risk.

¹¹ Hafalir and Loewenstein (2009) conducted a field experiment to see whether the use of credit cards might encourage greater spending. To their surprise, the authors found no evidence that credit cards increased overall spending and found that consumers who regularly fail to pay off debt (referred to as 'revolvers') reduced their expenditure.

Consumer confidence in their prospects¹² or in their ability to control future spending may lead them to overestimate their ability to pay back debt.

49. Credit providers may exploit consumer overconfidence. For example, credit card issues may offer free credit for a month and high charges on balances held for longer periods. The strategy enables card issuers to increase their revenue for the consumers who over estimate their ability to repay their balances in full.¹³

50. Consumer overconfidence with regard to future income and spending may contribute to distressed consumers entering into credit contracts under poor terms. Similarly consumer overconfidence, with regard to future income and spending, may result in consumers being unprepared for adverse events and use other credit to address short term needs.

51. Consumers may also be poor judges of risk as a result of other biases (see the companion paper). For example, the availability bias suggests that consumers will underestimate the risk of an economic downturn following a period of strong growth.

Choices over time

52. Consumer choices over time are often inconsistent — that is, they make choices in the present that their later selves may be unsatisfied with. These poor choices may reflect innate preferences for immediate consumption and problems of self-control.

53. As discussed in the companion paper, consumers have a bias towards current over future consumption. There is evidence that this preference for current consumption influences consumer credit markets. For example, Meier and Sprenger (2010), using choice experiments, found that individuals with higher present-bias also have higher credit card debt, suggesting that present-bias leads to greater spending which in turn leads to greater debt. Similarly, consumers may over spend because they are being guided by visceral impulses or because they overestimate the beneficial impact of a purchased item. The risk of these biases is compounded by consumer difficulty in estimating the rate at which debt can accumulate.

¹² Cebulla (1999) used a survey of around 1000 employed persons in Britain to compare actuarial risk assessments with respondents' subjective job risk assessments and their declared intention to take out private insurance. The author found that respondents on average underestimated their job risk and that perceived job risk was correlated with intentions to purchase insurance.

¹³ Consumer overconfidence has been used to explain why consumers appear to be unresponsive to changes in credit card interest rates (Ausubel 1991).

54. Poor choices over time are often framed in terms of problems of self-control and procrastination. O'Donoghue and Rabin (1998) argue that naïve procrastination by consumers may lead to consumers not planning their finances despite knowing that financial planning is both beneficial and important. They argue that people may defer planning to another time because they believe it is important and warrants additional attention that cannot be provided immediately. Naïve procrastination however leads to a continual deferral with the result that the financial planning may never occur.

55. Self-control also appears to be a problem for day to day consumer decisions. Consumers want to pay off their credit card balances, but would prefer to do so next month. A lack of self-control results in a continual deferral and an accumulation of charges.

Social concerns

56. Another behavioural concern is that consumer spending — and, as a result, borrowing behaviour — is influenced by the spending of others. Quite simply consumers may borrow so that they can spend to maintain status alongside others (more colloquially referred to 'keeping up with the Joneses'). People may borrow more (or save less) so as to spend to keep-up with others if they see greater benefit in getting ahead today than in the future (Frank 1985; Tooth; 2008). While such a strategy may benefit the individual, society would be better off if this spending was reduced. If people are worried about their relative level of expenditure then greater spending by an individual reduces the well-being of others. The problem is similar to that of an arms-race — if parties worry about relative expenditure then a joint agreement to reduce expenditure can be beneficial. Of note, status-seeking expenditure provides a rationale for discouraging current spending in favour of greater saving.

57. Social influences may also help to explain housing (and other asset) cycles. Some (e.g. Shiller 2007) argue that social influences have led to speculative asset 'bubbles'¹⁴, which in turn can lead to excessive borrowing to finance the inflated prices. Crowe (2009) finds evidence of irrational exuberance in the US housing market. He found that the housing cycle is more muted in areas where religious beliefs or 'values' are likely to make people less prone to participating in a speculative mania.

58. On the other hand, perceptions of fairness held by consumers may strongly influence the products offered by the consumer credit industry. Behavioural studies (see companion paper) repeatedly find that consumers are also worried about the fairness of outcomes. Strategies undertaken by lenders such as rationing

¹⁴ A bubble is generally thought to refer to increases in asset prices that cannot be explained by changes to the intrinsic value of the assets (relative to the value of other goods or services).

credit or charging very high interest rates may be perceived as unfair. Concerns about perceived fairness can lead to banks preferring to not participate in particular markets (e.g. lending to low income households) so as to preserve their reputation.

Summary of issues

59. The above discussion reveals a number of reasons why consumers may make poor choices with regard to consumer credit. Of note, consumers may make poor decisions independent of other influences because they suffer from biases (such as over optimism) and because they have difficulty in dealing with the complexity of the decisions. Consumers may also be influenced towards poor decisions. As discussed above, social influences are likely to encourage consumers to spend more (and thus borrow more) than is socially optimal. As with other industries, consumers are susceptible to influence by suppliers whose interests are not closely aligned with that of consumers.

60. The implications of these biases mean that some consumers are likely to:

- take on too much debt — for a set of reasons including that consumers are over confident, underestimate the impacts of compound interest and are encouraged to spend more by social pressures and by suppliers of credit.
- make poor choices on the types of products — as a result of individual behavioural biases (e.g. overconfidence) and supplier influence.

A further implication is that there is an inefficient level of effort expended by suppliers in attracting consumers and taking advantage of these biases.

Considerations

61. Before examining the potential regulation that might help to address these issues, it is worthwhile reflecting on a number of considerations.

Competition and waste

62. Although credit providers may exploit the behavioural biases of consumers, it does not follow that they will make above-normal profits. Competition in lending means that in the absence of barriers to entry, over time any excess profits (rents) will be dissipated through lower prices or higher costs. This is because if incumbent firms are making excess profits, new competitors will be encouraged to enter and offer better interest rates or terms, for the same level of service.

63. A key concern for the industry and policy makers is that competition does not lead to higher quality or lower cost products but rather leads to wasteful competition by firms in attracting consumers and using tactics to exploit consumer biases. This view is consistent with the search paradox discussed above, whereby due to consumer search costs (i.e. in obtaining information to compare competing products), firms are able to maintain high margins on customers acquired. To

attract customers, competing firms may face excessive costs in marketing. As noted by Agarwal et al. (2009), aggressive/manipulative sales tactics are costly.

64. This concern appears to be consistent with industry behaviour. For example, expenditure on marketing of credit cards is significant and appears to have intensified over time. Furelitti (2003) provides evidence (sourced from BAI Global) for the US. He notes that 'From 1991 to 2001, the number of mailed credit card solicitations increased fivefold to 5.01 billion. According to BAI Global, these solicitations in 2001 reached 79 percent of US households, which, on average, received five offers each month'. Similarly, a recent New Zealand study (Buzz Research 2008) found that most people have received unsolicited offers of a new credit card or an extension on their credit limit on their existing card. While such solicitations were found to be more commonly sent to those with higher incomes, almost half of those with earnings less than \$20,000 had received offers.

Differences in consumer behaviour

65. Not all consumers behave in the same way. It is commonly recognised that behavioural biases affect some consumers more than others. This is particularly the case in the consumer credit industry where consumers are often categorised into 'revolvers' (those who routinely pay off their debt and avoid interest repayments) and 'transactors' (those who regularly fail to pay off debt).

66. If firms cannot cheaply distinguish between two different types of customers then firms must offer similar terms to both types. Due to differences in behaviour, the cost implications of such terms will vary between consumers. For example, consumers who regularly pay off their debt will be better off than those who do not. Due to the resulting cross-subsidies, some borrowers may actually borrow below cost, while others get a bad deal. For this reason, in developing regulation, care is required to analyse how consumers signal their type and the distributional implications of reform.

67. The distribution of customer errors is also not uniform over the life stages. Agarwal et al. (2009) note that poor financial choices are more likely to be made by the young and old. They argue poor decision making by the old is a particular concern as there is more (financial resources) at stake, the elderly are less able to bounce back from mistakes, errors by the elderly are more likely to be related to cognitive impairment and retirees generally have fewer regulatory protections than young people.

Targeting the underlying problem

68. A challenge to regulating on the basis of behavioural economics is identifying and targeting the underlying problems. For example, in response to concerns that consumers have got themselves into trouble over taking on too much debt, there have been proposals aimed at encouraging people to borrow less.

69. However, efforts to curb consumer borrowing are essentially efforts to control consumer spending. It is thus reasonable to question whether policies should be more carefully directly aimed at spending.¹⁵ Furthermore, an appropriate policy toward borrowers is philosophically tricky: should the long-term prudent preferences be treated as worthier than the short-term, impulsive preferences? Regulations that restrict borrowing might help those biased toward present consumption achieve their long-term goals, but it would also prevent much desirable borrowing.

Self-regulation

70. Before considering government intervention in consumer credit, it is useful to consider how behavioural problems associated with this market can be overcome without recourse to government intervention. In many cases, consumers themselves correct the problems.

71. Although consumers may suffer from behavioural biases they may still learn from their mistakes. For example, Aragawal et al. (2008) found that consumers learn from the penalty fees applied in credit-cards. This is perhaps because every month they get feedback in the form of their statement and the opportunity to change their plans.

72. With regards to consumer credit there are also some opportunities for people to learn from others. For example, the reputation of the lender is a very significant factor in consumer choice for credit.¹⁶ Concerns for reputation may lead a firm to improve its lending practices.¹⁷

73. Shopping on the basis of reputation may be difficult in some credit markets, however. Peterson (2003) argues that reputation is unlikely to be an effective control in the market for high-cost credit. He argues that many higher-cost lenders do not invest significantly in building a reputation. This may be partly explained by the finding that borrowers from high-cost lenders are less likely to share reputation information 'because they often suffer from embarrassment and

¹⁵ Policies that discourage spending may not be palatable with retailers, and so may be politically unsustainable.

¹⁶ MORI (2003) found that 'When considering which loan or credit card to apply for, the foremost factor in people's minds is the reputation of the lender (deemed important by over four out of five people).'

¹⁷ Ramsay (2004) notes that 'When Citigroup took over the Associates finance company it was faced with the problems of being associated with allegations of predatory lending made against Associates that could tarnish Citigroup's reputation. In response it developed a number of initiatives to address these practices.'

shame over past credit failures and the prospect of imminent default.’¹⁸ An implication is that mainstream lenders with strong reputations can be deterred from entering high-cost credit markets for fear of high-cost lending practices impacting their own reputation in mainstream markets.

74. There is also substantial evidence that people often recognise their own vulnerabilities and rationally opt to regulate their own behaviour. Most famously, Homer’s Odysseus ordered his men to tie him to the mast so that he might hear the songs of the Sirens without falling into temptation. Similarly, people with substance addictions use a number of pre-commitment devices such as checking into rehabilitation centres or consuming medications that reduce their pleasure of the substance they wish to avoid (Bernheim and Rangel 2002). With regard to consumer credit, there is evidence that people may try to limit their freedom of manoeuvre, for example by choosing a low credit limit (or high late fees; see Shui and Ausubel 2005).¹⁹

75. Self-regulation has been used to explain some puzzles around credit card use. For example, Haliassos and Reiter (2007) examine whether problems of self-control can lead to the apparent paradox of the presence of high revolving of credit-card debt at the same time as high asset accumulation for retirement and liquid assets bearing low interest rates. They consider this paradox may be a result of people (either individuals themselves or sharing the role with their partners) assuming an ‘accountant’ and a ‘shopper’ role. The ‘accountant’ self considers the needs of the future self and ensure that assets are accumulated for future use. The ‘shopper’ self uses the credit-card as a line of credit for consumption smoothing. Credit card debt and credit limits are used as a mechanism to control spending.

76. Similarly consumers learn and use techniques to overcome their spending urges. The accountant–shopper model mentioned above (Haliassos and Reiter 2007) is an example of this. Self-control is an explanation for the popularity of Christmas Club saving accounts that provide a self-imposed limit on people’s access to money.

77. However, there are also limits to self-regulating behaviour (Agarwal et al. 2009). Self-regulation can be complex and difficult. People may underestimate their own fallibility and may procrastinate. Furthermore there are administrative costs to attempts to bind oneself.

¹⁸ Peterson (2003, p. 897) quotes a study that found ‘that less than a quarter of borrowers behind on their home mortgages ever mention their trouble to family or friends.’

¹⁹ A radical step is to literally freezing the credit card in ice
http://www.ehow.com/how_5168004_literally-freeze-credit-card.html

Behaviourally informed regulations — proposals and debates

78. Many policies that have been implemented or proposed for consumer credit cannot easily be justified on the basis of standard economic analysis. This section considers these policies through the lens of behavioural economics. It begins with a discussion of the variety of restrictions on consumer credit products.

Supply regulation

Product restrictions

79. The oldest forms of consumer credit regulation are usury laws that restrict the level of interest. Standard economic analysis would suggest that usury laws lead to an under-supply of credit: restricting some people from borrowing in their own best interest.

80. It is possible that usury laws were in part a means of addressing behavioural biases. Restrictions on the interest rate charged may have been seen as a simple method of addressing the concerns that consumers fail to appreciate the issue of compound interest and are unduly influenced or are overly optimistic in their ability to pay back debt.

81. A product restriction such as a cap on interest rates is however a blunt tool to address concerns created by behavioural biases. Such restrictions do not address the underlying cause for concern (e.g. overconfidence).

82. Restrictions on borrowing may also have adverse consequences. In some cases they restrict people from borrowing in their own best interest. A frequently cited concern is that restrictions on one form of credit (such as credit cards) will encourage substitution to other less attractive forms of credit such as fringe lending.

83. The size of this substitution effect is an empirical question that is open to debate. Littwin (2008) argues that the effect is not significant whereas Zywicki (2008) argues the effect is likely to be significant. Recently, Morgan and Strain (2008) examined the impact of a ban on payday loans in the US states of Georgia and North Carolina. They found that households in these states bounced more checks, complained more to the Federal Trade Commission, and filed for bankruptcy protection at a higher rate. This, they conclude, is consistent with the hypothesis that payday credit, despite its problems, is preferable to substitutes that are used if they are not available (e.g. fringe lending).

84. Restrictions on lending can also illicit a supply response whereby in response to restrictions, suppliers work around the restrictions to achieve the similar ends in a different form. For example, capping of interest rates may lead to lenders making greater use of other fees to boost revenue. This could be

potentially a preferable outcome if consumers are more able to assess the cost of fees than interest rates and thereby better understand the financial implications of debt. However, there is also a risk that the additional fees will not be transparent to the consumer. To address this problem in many jurisdictions where caps have been introduced the cap includes fees and other charges.²⁰

85. Given these considerations, product restrictions are a risky policy to address behavioural biases. However, behavioural economics helps to clarify why arguments for product restrictions continue and thus provide insight into designing appropriate policies that address the underlying concerns.

Responsible lending

86. If consumers themselves have difficulty making good decisions around borrowing, then a natural response is to consider whether greater responsibility can be placed on the lenders. Responsible lending regulations place greater responsibility on the lender to ensure that lending is consistent with the interests of the borrower.

87. A key argument for responsible lending provisions is that, despite having less information on personal circumstance of the borrower, lenders are often in a better position to assess what is an appropriate level of borrowing as they have more experience and are less likely to suffer from over-confidence or biased risk assessment.²¹ Conversely, it is argued that without responsible lending requirements suppliers may take advantage of vulnerable customers. Responsible lending provisions may also not be restrictive to consumers. While responsible lending may deter some consumers from borrowing, it may not restrict potential borrowers who are prepared to provide additional information on their ability to repay debt.

88. Responsible lending requirements are not without risk. Requirements can push-up lenders' costs which may be passed on to borrowers.²² Responsible lending requirements could encourage potential borrowers to seek alternatives (e.g. 'low-doc'²³ high-cost debt contracts) so as to avoid the additional responsible

²⁰ However, there is a risk that loopholes will be exploited (Dixon 2008, page 26).

²¹ However, there is the risk that sales agents of lenders may also suffer from over-confidence or may lack incentives to ensure that lending is reasonable. Lenders also suffer from information asymmetry, in the sense that it is more difficult for a lender to assess a customer's type (good risk or bad risk) than it is for the customer.

²² Arguably this impact will be small as lenders already need to undertake some assessments of ability to repay.

²³ 'Low doc' or 'non conforming' loans are loans (typically home loans) where the usual requirement on the borrower to provide information that confirms income (e.g. pay slips) is waived. Instead the borrower estimates income without verification by the lender.

lending information requirements. Another possible concern is that increasing onus on the lender, may reduce the incentive of the borrower to assess their own situation.

89. However, the argument for responsible lending provisions appears strong. The MCA recently completed (MCA 2011) a regulatory impact analysis of the responsible lending provisions for the CCFA Draft Amendments. In light of the potential benefits and costs (and experience with similar provisions in other jurisdictions) the MCA recommended that responsible lending provisions be included in the CCFA.

Disclosure, information and literacy

Product disclosure

90. A common response to the concern that consumers are confused by different product offerings is to regulate the extent of, or form of, the product information disclosed by lenders. In principle improved and standardised product disclosure could reduce consumer search costs and make it easier for consumers to compare products. This in turn could lead to greater cost-based competition and lower product costs (which might then be offset by reduced expenditure on marketing).

91. The standard economic argument against disclosure regulation is that disclosure regulation is unnecessary as competitive markets will encourage firms to reveal information that would counter consumer biases. However as demonstrated by Gabaix and Laibson (2004), firms may not have an incentive to debias consumers even if there is no cost to advertising.

92. The view that simpler and more consistent terminology would help consumers led to the *Truth in Lending Act* (TILA) being enacted in the United States in 1968. The TILA required lenders to use a uniform terminology for the annual percentage rate (APR) and disclose other aspects of the credit contracts (Peterson 2003). Prior to the TILA, important credit terms were provided to consumers in a myriad of different ways making comparison shopping extremely difficult and increasing the difficulty for consumers in determining what they actually had to pay.

93. Despite initial resistance, the general approach of the TILA has received broad acceptance. However, as early as 1977, less than ten years after its implementation, the Federal Reserve Board, argued that *behavioural research* was suggesting that “with more than a few ‘bits’ of information, consumers cease to read or retain any of the material offered” (as reported in Peterson 2003, p. 888).

94. Simplifying disclosure to just a few ‘bits’ is difficult. The TILA aimed to ensure consumers could compare products on the basis of the APR. As noted by the US Federal Reserve²⁴, one credit card may have several APRs. They list common APRs as the purchase APR, the introductory APR and the penalty APR and note that APRs can be fixed or variable, the latter of which may be based on different interest rates.

95. Credit providers have incentives to differentiate themselves and offer different product features, which can counteract the goal of simplified disclosure. For example, the BNZ currently²⁵ offers eight different credit cards which differ in terms of a large number of features including account fees, three interest rates (for purchases, cash advances and transfers of balances from other issuers), the type of rewards received and interest free days on purchase.

96. More recently there has been additional scepticism about the benefits that improved disclosure can bring (Agarwal et al. 2009; de Meza et al. 2008). There is evidence from field experiments that improved disclosure does not necessarily lead to materially improved financial decision making (Willis 2005).

97. In addition, while disclosure may improve the information provided to consumers, it does not necessarily improve how consumers use the information. Consumers can struggle to use information to make decisions. The challenges for consumers, and for regulators in developing disclosure standards, are compounded by the pace of product and marketing change in financial services.

98. Scepticism also exists for whether disclosure could help to address the problem of ‘shrouded attributes’ identified by Gabaix and Laibson (2005) that are common in consumer credit contracts. Clear and comparable information disclosure and cost-based prices for add-ons (in the manner of the *Credit Contracts and Consumer Finance Act 2003*) could potentially help consumers choose on the basis of these charges. However, consistent with the reasons and evidence noted above, Gabaix and Laibson note that ‘disclosure laws for credit cards and mortgages have met with only mixed success’ and are similarly sceptical of regulations that warn consumers to pay attention to shrouded costs.²⁶

99. In hindsight these challenges are not surprising given the nature of the consumer credit market and the nature of consumer behaviour. The complexity of consumer credit products combined with consumer difficulty in processing

²⁴ See <http://www.federalreserve.gov/creditcard/rates.html>

²⁵ See <https://www.bnz.co.nz/portal/site/bnz/Credit-Cards>. Accessed August 2012.

²⁶ Gabaix and Laibson (2005) also consider, but are sceptical of, harder regulations such as caps on mark-ups for shrouded attribute products as they are often in their view counterproductive.

complex information mean that regulated product disclosure is unlikely to prevent poor consumer choices. Improved product disclosure does not address the underlying problems of consumer bias in risk assessment and underestimation of compounding.

100. Furthermore, disclosure regulation is not without cost. There are additional administration costs associated with changes to disclosure.²⁷ Regulatory efforts in improving disclosure may come at an opportunity cost of regulatory efforts elsewhere — that is, a focus on improving product disclosure may distract regulators from more effective methods of addressing poor decision making by consumers.

101. Regardless, it is likely that industry and governments will continue to pursue improvements in disclosure, testing and trialling alternative forms. Firms can have an interest in clearer disclosure as it can result in common terminology and standards thereby reducing costs of bringing products to the market. In addition to lower administration costs, clearer disclosure may have direct benefits for consumers by lowering the cost in understanding and selecting products and helping to overcome the problem of high search costs.

Information and framing

102. An alternative focus of disclosure legislation, more closely aligned with the findings of behavioural economics, is to change the messages provided to consumers and how the information is framed.

Product warnings

103. Disclosure legislation, such as the TILA, prescribes clear disclosure of the contract terms but, for example, does not require lenders to warn consumers about the danger of the product.

104. Some commentators suggested that disclosure legislation should change emphasis to reflect that using credit, like tobacco, can be dangerous. Stein (2007) argues that disclosure should in addition warn consumers that credit cards are a dangerous product, instruct consumers how to minimize their risk and instruct consumers how to use act accordingly. Potentially such information could work to counter consumer biases, particularly with regards to choices over time and poor assessment of risks. For example, warnings may make consumers think again

²⁷ These can be significant. The Australian Bankers' Association (ABA) in a submission (9 October 2006) to a Regulation Benchmarking Study by the Productivity Commission, estimated that the Financial Service Reform compliance costs included: 'direct compliance costs for FSR implementation of \$3-\$40 million per bank, representing 0.5%-5% of operating income' and 'substantial indirect compliance costs.'; 'ongoing direct compliance costs of \$30-\$40 million per year, representing 0.5%-1.5% of operating income'; and 'Compliance is accounting for between 5-20% of senior management time and around 25% of board time.'

about purchases and lead to more controlled spending. Warnings could also make consumers more aware of risks to their ability to repay debt and the consequences of debt.

105. Warnings can be effective in changing behaviour. Cox et al. (1997) conducted a meta-analysis of the use of warnings from 15 studies across a range of products, hazards and safe-behaviours²⁸ and found that, while there was remarkable variance in effect, in general warnings increased the likelihood of safe behaviours. There is also some evidence from the financial services industry. Chater et al. (2010) conducted an experiment to test the effectiveness of warnings regarding adviser remuneration for retail investment products; they found that consumers were more likely to react to an adviser remuneration disclosure if it incorporated a warning.²⁹

106. Warnings have been introduced with regard to consumer credit. As noted below, a number of jurisdictions have implemented a ‘minimum payment warning’ on credit cards statements to alert consumers how long it takes to pay off the credit card using minimum monthly payments. However, there appear to be much greater scope to provide warnings to consumers on the purchase of high risk products. For example, if consumers face significant risks with particular types of products (e.g. high interest credit), then warnings may be an effective complementary measure to improved decisions.

107. Some care is required. The effectiveness of warnings depends on a number of factors and, in particular, good design (Argo and Main 2002; Cox et al. 1997). As with tobacco, such warnings may have limited effect for those whose behaviour is addictive. Such warnings may also lack effectiveness if consumers are overconfident in believing that the warnings do not apply to them. Warnings could also reduce well-being if they make some people feel worse without changing their behaviour.

108. Regardless, this appears to be an area worthy of further examination. It would appear possible to test empirically the extent to which consumers may respond to warnings and to the extent to which messages might be developed to target consumer biases in risk assessment and in underestimating compound interest. Furthermore it is a low-risk intervention that may be trialled.

²⁸ Examples included: products (automobiles, tile cleaner), hazards (physical injury, skin burns), and safe behaviours (wear seat belt, wear gloves and mask).

²⁹ The authors tested a number of disclosure statements including the addition of the second sentence (with and without emphasis) of “The advisor will be paid proportional to what you invest. Notice that this means that the advisor did not necessarily have your own investment earnings in mind when he gave his advice.”

Minimum payment

109. To address the problem that consumer use of the credit cards is influenced by how information is presented, policy makers have also sought to regulate disclosure of credit card statements. The United States *Credit Card Act 2009* (enacted in February 2010) requires new levels of disclosure by credit card issuers on: how long it will take the consumer to repay the balance if the consumer only makes minimum payments; and how much the consumer would need to pay each month in order to pay off the balance in three years. Such a policy has potential to draw attention to the risks of simply paying off the minimum and suggest a new ‘anchor’ point – that is the amount to pay off the card within three years.

110. The Ministry of Consumer Affairs (2009) has considered following United States legislation mandating greater disclosure around the financial implications of only making minimum payments on credit cards. The current issue paper has also suggested requiring credit card issuers to provide monthly statements with information about the true cost of interest repayments.

Supplier information

111. An alternative disclosure based strategy is to help consumers select providers of credit on the basis of their reputation. Supplier reputation is already an important consideration in consumer choice.³⁰ If consumers had more information on supplier reputation and/or were further encouraged to purchase on the basis of reputation then suppliers would need to be more careful to ensure that their reputation was maintained. This should lead them to be more careful to ensure that their customers are making better choices.

112. A potential policy direction may be to support consumers in assessing the reputation of providers of credit. There are however, limitations to this approach. Reputation is built over time and poor practices may only come to light during severe circumstances such as a major economic downturn. Furthermore, to protect their reputation suppliers may be discouraged to enter some markets. For example, the reputational risk is a potential reason why mainstream lenders are reluctant to participate in payday lending markets. Regardless, the importance of reputation in controlling poor lending practices remains a potential area for further exploration.

Literacy and capability

113. In a review of the effectiveness of disclosure requirements of TILA, Peterson (2003, p. 902) concluded that:

If the past thirty years of high-cost consumer credit experience teach one lesson, it is that truth is not enough —vulnerable high-cost debtors need understanding.

³⁰ A survey study conducted in the United Kingdom (MORI 2003, p. 2) found that “When considering which loan or credit card to apply for, the foremost factor in people’s minds is the reputation of the lender (deemed important by over four out of five people)”.

114. Consistent with these sentiments, many countries have targeted improving the financial literacy and capability of consumers in the hope that this would lead to better decisions and improve consumer search.

115. A common initiative is for a Government to run or subsidise programs that help provide information to consumers. For example, the Ministry of Consumer Affairs runs a ‘Truecost’ initiative³¹ that aims to support consumers purchase a car on finance by providing information on the total amount that the consumers will pay. Of note, the Truecost program is marketed to help those most at need — for example it includes Samoan and Tongan language advice sheets.³²

116. In New Zealand, the Retirement Commission leads a National Financial Literacy program with the mission that ‘New Zealanders are financially well-educated and can make informed financial decisions throughout their lives.’³³ The strategy was developed following a 2006 survey (Colmar Brunton 2006) of financial knowledge in New Zealand that showed that, although New Zealanders had a reasonable level of financial knowledge, they tended to struggle with concepts such as compound interest and mortgages. A strong correlation was found between socio-economic status and poor financial capability.

117. Similar surveys (with similar results) and programs have been implemented elsewhere.³⁴ The Financial Services Authority (FSA) in the United Kingdom (UK) has been at the forefront of examining the effectiveness of financial literacy. Following a 2006 survey³⁵ that found many UK consumers lacked the confidence and capability to make effective decisions about their money, the FSA launched a national strategy aimed at improving the financial capability of the UK population through education programs in schools, higher education and workplaces and a range of other programs.

118. Subsequently, the FSA also looked to examine the link between financial capability and improved outcomes from an examination of existing policies

³¹ See <http://www.consumeraffairs.govt.nz/for-consumers/motor-vehicles/truecost>.

³² Also noteworthy is that the program is targeted at consumer finance — the information provided aims to support the consumer understanding of the total cost of financing a vehicle rather than the total cost of owning and running a vehicle.

³³ <http://www.retirement.org.nz/what-we-do>

³⁴ Similarly, in 2005, the Australian Government founded the Financial Literacy Foundation aimed at giving ‘all Australians the opportunity to increase their financial knowledge and better manage their money’. Details about the foundation can be found at www.understandingmoney.gov.au

³⁵ Levels of Financial Capability in the UK: Results of a baseline survey, FSA March 2006. Financial Capability in the UK Establishing a Baseline, FSA, March 2006

(Atkinson 2008) and from the viewpoint of behavioural economics (de Meza et al. 2008). Atkinson (2008) found that there had been relatively little work on financial capability in the UK or other countries, and that there was little credible policy evaluation showing the incremental impact of financial capability. In a review of the international evidence de Meza et al. (2008) concluded that ‘financial capability initiatives which are designed to inform and educate should be expected to have a positive but modest impact.’

119. Willis (2008a and 2008b) raises stronger concerns with financial literacy education (FLE) programs. She argues that the FLE programs are unlikely to be effective and that the programs cannot only be costly but also lead to adverse outcomes. A key argument is that financial literacy education is just too difficult due to the pace of change in financial services and limits of consumer skills in making financial decisions. The pace of innovation in the consumer credit sector is swift³⁶ and, in the view of Willis, so great as to make it too difficult a task for consumers to keep-up. In support of her argument, she notes that regulators themselves have admitted to the difficulties keeping pace with financial services innovation. Many of Willis’s other concerns reflect behavioural issues. A key concern for Willis is that consumers suffer from deeply ingrained behavioural biases. It is very difficult to shift consumers from these biases.

120. With regard to the costs of FLE, Willis lists the direct costs of undertaking the FLE programs and the opportunity costs of not pursuing other policies. Furthermore, she notes evidence that suggests that higher levels of financial capability are correlated with more significant mistakes, which, she interprets as possibly being the result of higher financial education resulting in over-confidence.³⁷

121. There are some potential opportunities. Willis (2008a) notes evidence which suggested that educational programs did not improve financial literacy scores but did improve financial outcomes (saving behaviour). She suggests that this raises the possibility that financial education is more perhaps aimed at establishing norms or rules-of-thumb that people can practically use, a possibility supported by de Meza et al. (2008). There is evidence that a rule-of-thumb approach has greater effect than general education. Fischer et al. (2010) examined

³⁶ This is despite the core service provided by financial products is reasonably stable. Nobel Laureate Joseph Stiglitz reports that Paul Volcker (former Chairman of the Federal Reserve Board) ‘recently commented that the only financial innovation the American financial markets had made that increased our productivity was the ATM machine.’ Source: <http://www.abc.net.au/rn/backgroundbriefing/stories/2010/2973129.htm>

³⁷ A similar finding has been found in driver training programs, for which there is evidence that early driver training programs led to over-confidence, increased risk taking and increased accident rates. More recent and more successful programs have involved an increased focus on making drivers aware of their limitations through self-evaluation (Sandroni and Squintani 2004).

the impact of financial training for micro-entrepreneurs in the Dominican Republic. They found no significant improvement (in firm-level and individual outcomes) from a standard, fundamentals-based accounting training, but that simplified, rule-of-thumb training³⁸ produced significant and economically meaningful improvements in business practices and outcomes.³⁹

122. A common finding of researchers (Atkinson 2008; de Meza et al. 2008; Willis 2008a, 2008b) who have investigated the literature on financial literacy education is that there are many gaps in our understanding of how consumers make decisions and the types of interventions that may be effective. There appears great scope for further research in understanding the consumer decision making process around consumer credit products.

Soft paternalistic policies

123. Soft paternalistic policies are policies that attempt to influence (i.e. nudge) consumers to make choices without restricting their choices.⁴⁰ There have been a number of soft paternalistic consumer credit policies that have been implemented or proposed around the world.

Default products and options

124. A form of soft paternalism is to offer consumers default product or default product options. Because consumers are more likely to choose defaults this approach can be used to influence consumers to make better decisions while not restricting the choice of those who wish to opt for an alternative to the default. The New Zealand ‘Kiwisaver’ is a prominent example of a default financial service product whereby workers are by default enrolled in a pension plan, but they have the choice of opting out.

125. Examples of the default products and options approach in consumer credit based on behavioural economics are provided by Barr et al. (2008). With regard to mortgages, they propose that lenders be required to provide a default mortgage product such as a fixed rate, self-amortizing 30 year mortgage loan. Under their proposed scheme lenders could also provide any other products outside of this default package, but that the borrowers would get the standard ‘vanilla’ mortgage product offered unless they chose to opt out. The authors argue that this approach

³⁸ Rule of thumb training included strategies for separating business and personal accounts and simple methods of estimating business profits.

³⁹ Rule-of-thumb rules can also be effective; Winter et al. (2011) conducted simulations on life-cycle decisions and found that simple rule-of-thumb choices performed well compared to more sophisticated decision techniques.

⁴⁰ See the companion paper for a more in-depth discussion.

would help to mitigate the problem of borrowers taking out mortgages that they cannot understand or afford.

126. Barr et al. (2008) also propose other default options for consumer lending products. Their proposals include an opt out payment plan for credit cards whereby card holders would by default be required to make the payment necessary to pay off their balance over a relative short time period.

127. Such proposals would appear to have the benefit of improving, by default, the choices of consumers. However, consistent with the commonly raised objections to soft paternalistic policies (see companion paper), there are a number of challenges. Such policies require selection of a default, or ‘vanilla’ product, which is not costless. Selection of a default, or ‘vanilla’, product does not stop lenders from promoting inappropriate mortgage products. In their proposal for a standard mortgage product, Barr et al. (2008) note that the ‘precise contours of the standard set of mortgages would be set by regulation’. Such design details of the ‘vanilla’ product may be hotly contested and there is a risk that government failure will lead to sub-optimal choice as to the ‘vanilla’ product.

128. A requirement to offer a ‘vanilla’ product may also deter niche suppliers who wish to focus on specific offerings. For example, a requirement for lenders to provide the default product may raise the costs of some lenders who would not otherwise offer the product. Similarly a focus on ‘vanilla’ products may deter innovation.

129. Also as noted in the companion paper, a common concern with paternalistic nudges towards ‘vanilla’ products is that they may reduce learning from trial and error. Arguably, this objection is less relevant for long term, high cost consumer products like mortgages, where mistakes are harder to learn from and to remedy.

Cooling off policies

130. Another common soft paternalist policy is to require lenders to provide a cooling-off period during which borrowers may choose to reverse their decision without severe penalty. Cooling-off periods would appear to provide a means of addressing behavioural concerns that consumers have difficulty in processing information by allowing consumers more time to reflect on their purchase decision. However, cooling-off periods do not need to be justified by behavioural biases — Suppliers may wish to provide cooling-off periods to consumers as a means of signalling product quality. Cooling-off periods are not without cost. For example, a supplier offering a cooling-off period is unable to use the credit contract as security or sell it for a time —reducing its value.

Regulatory process

131. The consumer credit industry is also a useful case study for highlighting how behavioural economics research is being used in regulatory reform and the challenges of regulating on the basis of behavioural economics.

132. As advocated in the companion paper, there is value in regulatory deliberation and policy discipline. The programs to improve financial literacy and capability are useful cases. In response to the findings from financial literacy surveys that many consumers did not have a good understanding of financial products they may use, many programs aimed at improving financial literacy have been implemented internationally. As discussed above, the focus on financial education and disclosure may have detracted from insufficient investigation of other programs. Financial services regulation is an area which may have suffered from biases in regulatory decision making. For example, Willis (2008a) argues that policies for improved financial literacy education have been driven more by ‘ideology’ than considered research. Regulatory scope creep has also been a concern. For example, in Australia, the Financial Services Regulation (FSR), which was primarily targeted at investment products, imposed common disclosure requirements across a range of financial services products including general insurance products (but notably excluded credit products).

133. The most prominent use of behavioural research in the regulatory process of consumer credit has been in problem identification. Poor consumer choices have long motivated intervention by Government in the consumer credit industry. However, as noted earlier, a challenge with analysing decisions involving risky outcomes is distinguishing between poor outcomes and poor choices. Behavioural research offers the prospect of moving beyond focussing on poor outcomes and focussing more on where and why consumers make poor choices.

134. Behavioural research is now also increasingly being considered in developing interventions in consumer credit. Some of the proposals developed and advocated by behavioural economists with regard to the consumer credit industry are now being considered and used in Government policy. For example, a proposal of the Ministry of Consumer Affairs (2009), based on behavioural research, is ‘restricting unsolicited credit and finance card increases such that credit limit increases can only be made when the borrower has actively opted-in’. Such approaches would appear to be a welcome addition to policy development.

135. Another step in the regulatory process for consumer credit in which behavioural economics is being increasingly considered is in evaluating proposed regulation. There are, however, risks with using behavioural economic research to evaluate but not develop policy.⁴¹ A common concern of behavioural economists

⁴¹ For example, in a recent Australian regulatory impact statement on consumer credit, behavioural economics research is first mentioned in assessing the issues associated with alternative proposals.

is that because the field is still developing, there is a large risk that behavioural research is used to justify, rather than inform, policy choices.

Conclusion and summary

136. A number of conclusions for the implications of behavioural economics to regulatory reform and in particular to consumer credit can be drawn from this case study.

137. First, behavioural economics can provide insights into issues that may be considered for regulatory reform in the consumer credit industry. The lens of behavioural economics allows us to see that there are clear reasons why some consumers are likely to take on too much debt and make poor product choices. Specifically, consumers have behavioural biases that include being over-optimistic, underestimating the effects of compound interest and being overly focussed on the present. Furthermore consumer decisions may be distorted by others. Suppliers, whose interests may not be closely aligned with that of consumers, can influence consumer behaviour. There is evidence that consumer spending, and thus borrowing, is influenced by social spending.

138. Behavioural economics is particularly relevant and useful to analyses of consumer credit because consumer decisions involve an assessment of risk. As is discussed in this paper and the companion paper, consumers suffer from behavioural biases and difficulties when it comes to assessing risk. Where risk is involved it is difficult for policy makers to assess ex-ante whether poor decisions are being made. An advantage of behavioural analysis is that it focuses more on how decisions are being made and the distortions that may occur.

139. Behavioural economics is also useful in developing and evaluating regulatory reforms. The presence of inefficiencies in consumer credit, begs the question whether regulation might help to address some of these issues. As is discussed in this paper there are a broad range of regulations that have been trialled and proposed.

140. Second, behavioural economics is useful in analysing these regulations for a number of reasons. First, behavioural economics helps provide an understanding of why particular regulations may have found favour. For example, while usury laws that restrict interest rates cannot be justified based on standard economic analysis, restrictions on interest rates may have been seen as a means of addressing the concern that consumers underestimate some risks and compound

‘Responsible Lending Practices in relation to consumer credit cards: Consultation Regulatory Impact Statement’, Prepared for the Ministerial Council on Consumer Affairs, August 2008.

interest. By understanding the underlying problems, more appropriate policies might be developed.

141. Behavioural economics is also useful in helping to assess risks associated with planned policies. In light of the findings of behavioural economics, it is not surprising that efforts to reform product disclosure and improve financial literacy in consumer credit and other financial services have met with limited success. The effect of improved financial literacy and disclosure standards has at least in part been countered by increased product complexity. Such policies do not also target the underlying biases in consumer behaviour.

142. Insights from behavioural economics can be used to refocus existing initiatives and develop new interventions. With regards to consumer credit, there are a number of promising areas for further examination. For example, the focus on financial literacy might be usefully shifted towards more practical advice. One possibility is along the lines of consumer warnings to improve consumer understanding of their own limitations and the risks of certain products.⁴² Another potential policy is to help consumers by developing simple rules of thumb.

143. Another potential area of investigation is to more closely examine how to support the consumer in the search process they undertake. For example, if, as evidence suggests, consumers often shop on the basis of reputation, a useful line of enquiry is to assess whether more could be done to support consumers in assessing the reputation of providers in helping their customers choose the most appropriate products.

144. Given consumer biases in decision making, it is also natural to examine whether suppliers could be used to help consumers make better choices. Responsible lending practices such as those being introduced are one such approach. In avoiding financial distress the interests of suppliers and consumers are somewhat, but not directly, aligned. A useful line of inquiry might be to consider what credit suppliers might do if there was greater alignment of interests.

145. The challenge with applying behavioural research in policy is that the field is still emerging. There is a risk that behavioural research is used on the fringes of policy: decision-makers use it to justify rather than inform policy choices. On the other hand, over-zealous use of an incomplete science comes with risks of its own. Interventions may stifle innovation in consumer credit products or result in higher credit costs being passed on to consumers. Furthermore, interventions may restrict the supply of 'good credit' to customers who make good choices. For this reason, care must be taken to ensure that regulation does not result in a situation where

⁴² Such an approach has proved successful in driver safety education, where benefits are seen from shifting from improving drivers' skills, which might increase their sense of overconfidence, to increasing their appreciation of their limitations (Sandroni and Squintani 2004).

sensible consumers cross-subsidise the less sensible too much, or where the less sensible are not given an opportunity to 'learn' from their borrowing mistakes.

146. More research needs to be undertaken. Given the challenges with assessing outcomes, there is significant value in research that examines the process of how consumer credit decisions are made and in particular to test the theories of behavioural economics. For example, it would be useful to understand how much indebtedness is associated with consumers being overconfident or underestimating the effects of interest repayments.

References

- Agarwal, Sumit., John Driscoll, Xavier Gabaix and David Laibson. 2008. *Learning in the credit card market*. NBER Working Paper No. 13822.
- Agarwal, Sumit., John Driscoll, Xavier Gabaix, and David Laibson. 2009. *The Age of Reason: Financial Decisions over the Life-Cycle with Implications for Regulation*. Brookings Papers on Economic Activity 2: 51-117.
- Agarwal, Sumit., Souphala Chomsisengphet, Chunlin Liu, Nicholas Souleles. 2006. *Do consumers choose the right credit contracts?* CFS Working Paper Series 2005/32, Center for Financial Studies.
- Akerlof, George., and Robert Shiller. 2009. *Animal spirits: How human psychology drives the economy and why it matters for global capitalism*.
- Anae, Melani., Eve Coxon, Ieti Lima, Lusi Atiga and Hilary Tolley. 2007. *Pacific consumers' behaviour and experience in credit markets, with particular reference to the 'fringe lending' market*.
- Argo, Jennifer., and Kelly Main. 2002. Warning! Proceed With Caution: A Meta-Analysis of the Effectiveness of Warning Labels, in Broniarczyk, S and Nakamoto, K (eds.) *Advances in Consumer Research*. Association for Consumer Research, pp. 235-236.
- Ausubel, Lawrence . 1991. The failure of competition in the credit card market. *American Economic Review* 81(1): 50–81.
- Barr, Michael., Sendhil Mullainathan and Eldar Shafir. 2008. *Behaviorally informed financial services regulation*. Washington DC:New America Foundation.
- Bentham, Jeremy. 1787. *Defence of usury*.
- Bernheim, Douglas., and Rangel, Antonio. 2002. *Addiction and Cue-Conditioned Cognitive Processes*. NBER Working Paper No. W9329.
- Bertrand, Marianne., Dean Karlan, Sendhil Mullainathan, Eldar Shafir and Jonathan Zinman. 2010. What's advertising content worth? Evidence from a consumer credit marketing field experiment. *Quarterly Journal of Economics* 125(1): 263–305.
- Bertaut, Carol and Michael Haliassos. 2006. *Credit Cards: Facts and Theories* CFS Working Paper Series 2006/19, Center for Financial Studies.
- Bertaut, Carol., Michael Haliassos and Michael Reiter. 2009. Credit Card Debt Puzzles and Debt Revolvers for Self Control. *Review of Finance* 13(4): 657-692.
- Birkinshaw, Christopher. 2005. Making disclosure meaningful: A proposal. *Canterbury Law Review* 30.

- Blitz, Rudolph and Millard Long. 1965. The economics of usury regulation. *The Journal of Political Economy* 73(6): 608–619.
- Brandt, William and George Day. 1974. Information disclosure and consumer behavior: An empirical evaluation of truth-in-lending *University of Michigan Journal of Law Reform* 7: 297-328.
- Buzz Research. 2008. *The Marketing of Credit to New Zealanders*, April 2008, available from Buzz Research www.buzzchannel.co.nz.
- Cagney, Paula and Debbie Cossar. 2006. *Fringe Lenders in New Zealand: Desk Research Project*. Wellington: Research New Zealand.
- Carlin, Bruce. 2009. Strategic Price Complexity in Retail Financial Markets. *Journal of Financial Economics* 91: 278-287.
- Cebulla, A. 1999. A geography of insurance exclusion: perceptions of unemployment risk and actuarial risk assessment, *Area*, 31: 111-121.
- Chater, N., Inderst, R., Huck, S., 2010. *Consumer decision-making in retail investment services*. Report to the European Commission (SANCO).
- Colmar Brunton. 2006. *ANZ-Retirement Commission Financial Knowledge Survey*, March 2006 Research Report for the Ministry of Economic Development.
- Colmar Brunton. 2011. *Using a third tier lender: experiences of New Zealand borrowers*, August 2011.
- Cox, E., Wogalter, M., Stokes, S., and Murf, E. 1997. Do product warnings increase safe behavior? A meta-analysis. *Journal of Public Policy & Marketing*, 16 (2): 195-204.
- Crowe, Christopher. 2009. *Irrational Exuberance in the U.S. Housing Market: Were Evangelicals Left Behind?* IMF Working Paper. WP/09/57.
- de Meza, D., Irlenbusch, B., Reyniers, D. 2008. *Financial Capability: A Behavioural Economics Perspective*, Report prepared for Financial Services Authority', Consumer Research Paper 69.
- Diamond, Peter. 1971. A Model of Price Adjustment. *Journal of Economic Theory* 3(2): 156–168.
- Dixon, Nicolee. 2008. *Caps on Payday Loans*, Queensland Parliamentary Library Research Brief No 2008/04.
- Evans, David and Wright, Joshua. 2009. *The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit*. George Mason Law & Economics Research Paper No. 09-50.
- Families Commission. 2009. *Escaping the debt trap: Experiences of New Zealand families accessing budgeting services*. Research report 6/09.

- Fischer, G., Drexler, A. and Schoar, A., *Keeping it simple: Financial Literacy and Rules of Thumb*, 2010, paper presented at CEPR Development Economics Workshop, 8-9 October 2010.
- Frank, Robert. 1985. *Choosing the Right Pond: Human Behavior and the Quest for Status*. New York: Oxford University Press.
- Furletti, Mark. 2003. *Credit Card Pricing Developments and their Disclosure*. Federal Reserve Bank of Philadelphia Payment Cards Center Discussion Paper No. 03-02.
- Gabaix, Xavier and Laibson, David. 2005. *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*. MIT Department of Economics Working Paper No. 05-18.
- Glaeser, Edward and Jose Scheinkman. 1998. Neither a borrower nor a lender be: An economic analysis of interest restrictions and usury laws. *Journal of Law and Economics* 41: 136.
- Gross, David and Nicholas Souleles. 2002. Do Liquidity Constraints and Interest Rates Matter for Consumer Behavior? Evidence from Credit Card Data, *Quarterly Journal of Economics*, 117, 149-85.
- Hafalir, Elif Incekara and George Loewenstein. 2009. *The Impact of Credit Cards on Spending: A Field Experiment*. Working paper Available at SSRN: <http://ssrn.com/abstract=1378502>.
- Haliassos, Michael and Michael Reite. 2007. Credit Card Debt Puzzles. CFS Working Paper No. 2005/26.
- Hathaway, Ian and Sameer Khatiwada. 2008. Do Financial Education Programs Work? FRB of Cleveland Working Paper No. 08-03.
- Holmes, George. 1892. Usury in law, in practice and in psychology. *Political Science Quarterly* 7(3): 431-467.
- Hull, Leslie. 2003. *Financial deregulation and household indebtedness*. Reserve Bank Discussion Paper.
- Laibson, David. 1997. Golden eggs and hyperbolic discounting. *Quarterly Journal of Economics* 112(2): 443-477.
- Legge, J and Heynes, A. 2008. *Beyond Reasonable Debt: A Background report on the indebtedness of New Zealand families*. Research report 8/08 December 2008. Families Commission and Retirement Commission, Wellington. Available at www.familiescommission.govt.nz.
- Legge, J. 2009. *Beyond Reasonable Debt: Part Two: The extent to which financial behaviour can explain over-indebtedness amongst New Zealand families*. A joint Families Commission and Retirement Commission report. Research Report No 3/09. Available at www.familiescommission.govt.nz.

- Levitin, Adam. 2009. *The Consumer Financial Protection Agency*. Pew Financial Reform Project, Briefing Paper, No. 2, 2009; Georgetown Law and Economics Research Paper No. 1447082.
- Littwin, Angela. 2008. *Testing the Substitution Hypothesis: Would Credit Card Regulation Force Low-Income Borrowers Into Less Desirable Lending Alternatives?* 2009 U. ILL. L. REV. 403, 431.
- Meier, Stephan, and Charles Sprenger. 2010. Present-Biased Preferences and Credit Card Borrowing. *American Economic Journal: Applied Economics*, 2(1): 193–210.
- McCall, Brian. 2008., Unprofitable Lending: Modern Credit Regulation and the Lost Theory of Usury. *Cardozo Law Review*, 30(2).
- Mill, John Stuart. 1848. *Principles of political economy*.
- Ministry of Consumer Affairs. 2009. *Review of the operation of the Credit Contracts and Consumer Finance Act 2003*. September.
- Morgan, Donald and Michael Strain. 2008. *Payday Holiday: How Households Fare After Payday Credit Bans*. FRB of New York Staff Report No. 309.
- Market and Opinion Research International (MORI). 2003. *Consumer Awareness of Credit Issues*, Research Study conducted for Department of Trade & Industry.
- Orr, Adrian. 2006. *Towards a framework for promoting financial stability in New Zealand*. Speech presented to The Institution of Professional Engineers New Zealand, March 22.
- Peterson, Christopher. 2003. Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act. *Florida Law Review*, Vol. 55, pp. 807-903.
- Sandroni, A and Squintani, F. 2004. *A Survey on Overconfidence, Insurance and Self-Assessment Training Programs*. Mimeo.
- Schwartz, Alan, and Wilde, Louis. 1979. Intervening in markets on the basis of imperfect information: A legal and economic analysis. *University of Pennsylvania Law Review* 127: 630-82.
- Shiller, Robert. 2007. *Understanding Recent Trends in House Prices and Home Ownership*. Cowles Foundation Discussion Paper No. 1630; Yale Economics Department Working Paper No. 28; Yale ICF Working Paper No. 07-16.
- Shui, Hayan and Lawrence Ausubel. 2005. Time inconsistency in the credit card market. *Mimeo*. University of Maryland, 2005.
- Smith, Adam. 1789. *Wealth of nations*.
- Stango, Victor and Jonathan Zinman. 2009. Exponential growth bias and household finance. *Journal of Finance* 64(6): 2807–2849.

- Stein, David. 2007. Wrong Problem, Wrong Solution: How Congress Failed the American Consumer. *Emory Bankruptcy Developments Journal* 23(2).
- Stewart, Neil. 2009. The cost of anchoring on credit-card minimum repayments. *Psychological Science* 20(1): 39–41.
- Stiglitz, Joseph. 1979. Equilibrium in Product Markets with Imperfect Information. *The American Economic Review* 69(2). Papers and Proceedings of the Ninety-First Annual Meeting of the American Economic Association (May, 1979), pp. 339-345.
- Stiglitz, Joseph and Weiss, Andrew. 1981. Credit rationing in markets with imperfect information. *The American Economic Review* 71(3): 393–410.
- Thaler, Richard and Sunstein, Cass. 2008. Disclosure is the best kind of credit regulation. *WSJ*. 13 August.
- Tooth, Richard. 2008. *Status and Saving - Economics, Theory, and Evidence*. Vdm Verlag.
- Warren, Elizabeth. 2007. Unsafe at any rate. *Democracy: A Journal of Ideas* 8.
- Willis, Lauren. 2005. Decision-making & the Limits of Disclosure: The Problem of Predatory Lending. Loyola-LA Legal Studies Research Paper No. 2005-14.
- Willis, Lauren. 2008a. Evidence and ideology in assessing the effectiveness of financial literacy education, *Journal of Consumer Affairs*. May.
- Willis, Lauren. 2008b. Against consumer financial literacy education. *Iowa Law Review*, 94(1).
- Woodward, Susan. 2003. *Consumer confusion in the mortgage market*. Sand Hill Econometrics.
- Zywicki, Todd. 2008. Credit Cards and Bankruptcy. ExpressO. Available at: http://works.bepress.com/todd_zywicki/3.
- Winter, J., Schlafmann, K and Rodepeter, R. 2011. Rules of Thumb in Life-Cycle Saving Decisions, University of Munich Discussion Paper No. 2011-16, available at <http://epub.ub.uni-muenchen.de/12334/>.