O'MELVENY & MYERS LLP

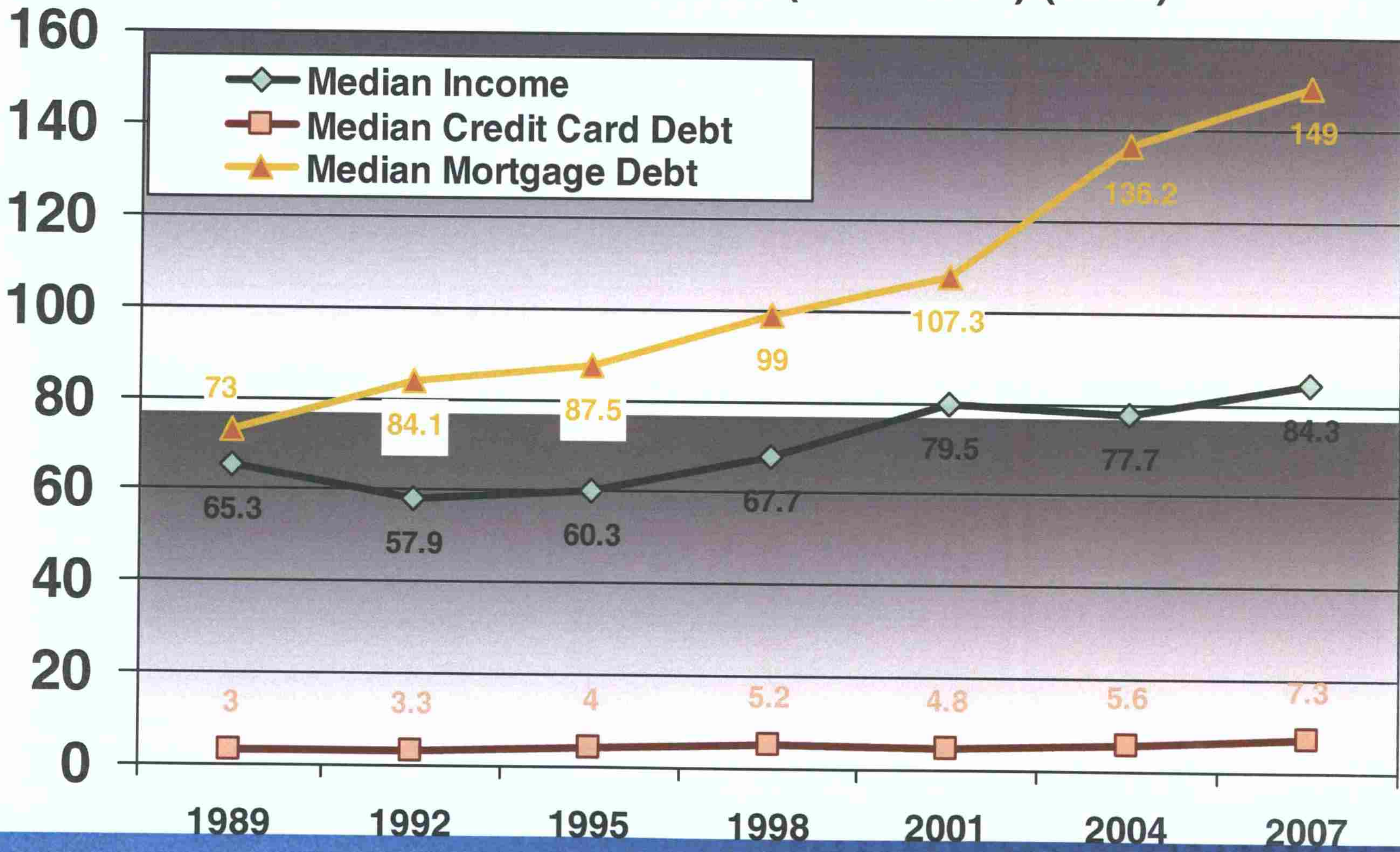
Thomas P. Brown
NYU And NY Federal Reserve Bank
January 2010

# It's Not What You Think

## Consumer Credit And The Financial Crisis

# The Big Picture

## Mean Income And Consumer Debt (1989-2007) (000s)



- The claims of neo-paternalists

- The empirical case against neo-paternalism

- If not a consumer protection problem, then what?

# Behavioral Economics
## Human beings are hopelessly flawed

- Five general deviations from the traditional rational choice model:
  - (1) Myopia or hyperbolic discounting; (2) cumulative cost neglect; (3) procrastination; (4) unrealistic optimism; (5) miswanting
- These deficiencies amount to a market failure
- Competition can't be trusted to yield "efficient" outcomes if consumers make bad decisions

# Hyperbolic Discounting
## A More Formal Description

- Future effects are heavily discounted relative to current effects
- Longer term future effects are only slightly more discounted than more immediate, but still future, effects.
- This leads people to overweight current benefits relative to future costs.

# The Rest

## Remaining flaws are fairly intuitive

- Cumulative cost neglect

  A series of small losses somehow cost less than a single loss of the same amount
- Procrastination

  People don't do what they should when they should
- Unrealistic optimism (or magical thinking)

  People systematically overestimate the likelihood that good things will happen to them
- Miswanting

  People buy today (and thus pay for tomorrow) stuff that isn't good for them

## Seduction By Plastic

### “Features” line-up with “flaws”

- Loan acquisition separate from loan use
- Consumers can go into debt a little at a time
- Receipt of goods is separate in time (and often place) from payment
- Non-contingent prices are low and fixed
- Contingent prices are high and variable

## With Unfortunate Consequences
### Dragging consumers into bankruptcy

- Growth in credit card debt is leading to a rise in debt-to-income levels
- Credit card debt has taken over the entire installment debt category
- "Credit card debt has led the way to bankruptcy for an increasing number of Americans"

# Rewards Cards
## Poster child for industry critics

- Rewards programs lead to systematic overuse of credit cards

*Ronald Mann*

- Rewards programs prey upon consumers' tendency to overweight the present

*Oren Bar-Gill*

- Rewards cards reduce the "pain of paying," leading to over-indebtedness

*George Loewenstein*

- The claims of neo-paternalists

- The empirical case against neo-paternalism

- If not a consumer protection problem, then what?

# Seems Like A Big Leap
## What's the evidence?

Do rewards cards actually lead consumers to incur larger debts?

**-OR-**

Are consumers less likely to revolve on rewards cards than other cards?

# Let's Test It And See

- Howard Beales and Lacey Plache examined effect of rewards on revolving behavior
- Two-step analysis
  - Do people revolve balances after they acquire rewards cards?
  - Does the **rewards** feature increase or decrease the tendency to revolve?

# Payment Panel
## Representative sample of card users

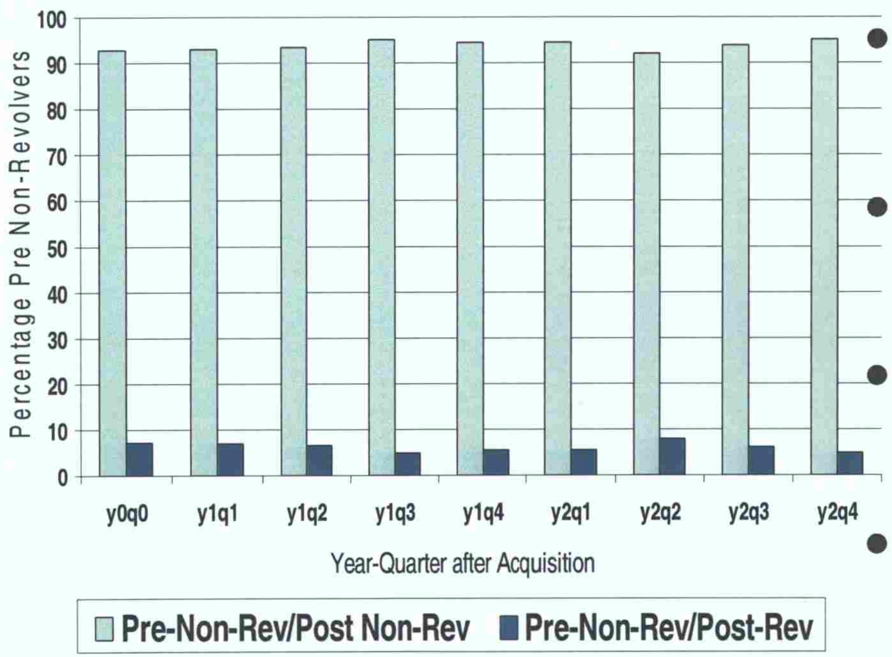
- Each quarter, three panels of 1,600 are drawn from a national sample of 475,000 households
- Must be 18, have 1 credit card and annual income greater than $10,000
- Collect data on individual and household, all transactions greater than $5 and payment cards
- Rewards cards results based on acquisition of ~7,700 cards and ~43,000 observations
- All cards results based on acquisition of ~26,000 cards and ~200,000 observations

# Step One
## Impact of card acquisition

| Behavior Before Acquisition | Behavior After Acquisition |
|---|---|
| Non-revolvers 43% | Don't Revolve |
| | Revolve |
| Revolvers 57% | Revolve |
| | Don't Revolve |

Percentage of reward acquirers

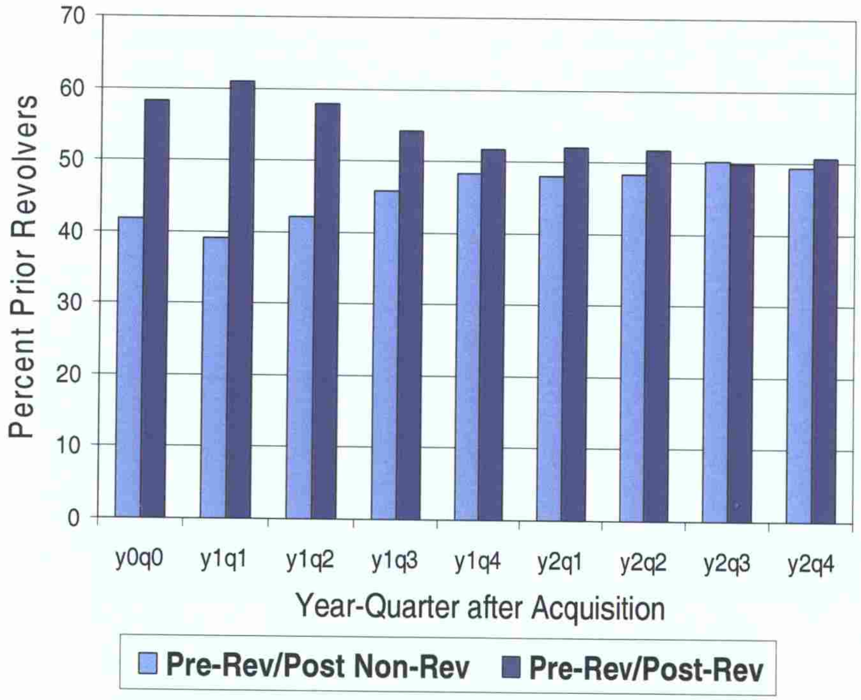
# Prior Non-revolvers
## Revolve after getting rewards card?




- Very unlikely to revolve on a new rewards card
- 92% do not revolve in Q1 after card acquisition
- Revolving behavior ebbs over time
- 95% are not revolving two years later

Source: Beales/Plache

# Prior Revolvers
## Revolve after getting a rewards card?




Source: Beales/Plache

- Pre-period revolvers are more likely to revolve
- 58% will revolve on a new rewards card in Q1
- Revolving behavior **declines** over time
- Two year later, only 50% are revolving

## Step Two
### Do rewards explain revolving?

- Used a model to identify variables that explain revolving behavior
- Examined which variables explain revolving behavior, *e.g.*,
  - Prior revolving behavior
  - Card features
  - Demographics

# Predicting Revolving Behavior
## One dominant factor

- Behavior prior to card acquisition is biggest single factor by a wide margin
  - Revolved before and you're very likely to revolve after
  - Didn't revolve before and you're very unlikely to revolve after
- Everything else is secondary

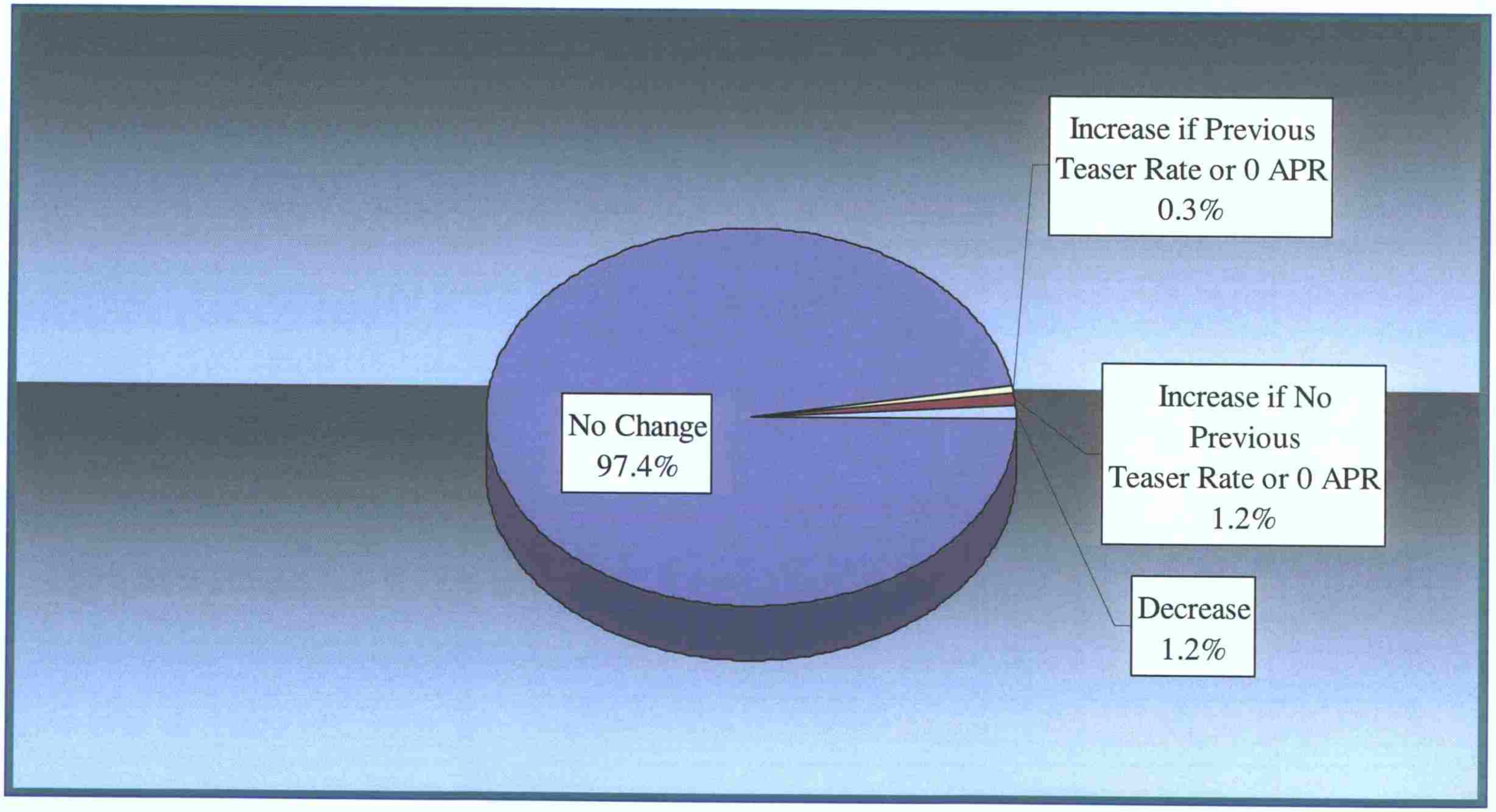
# Predicting Revolving Behavior

## Many Secondary Factors

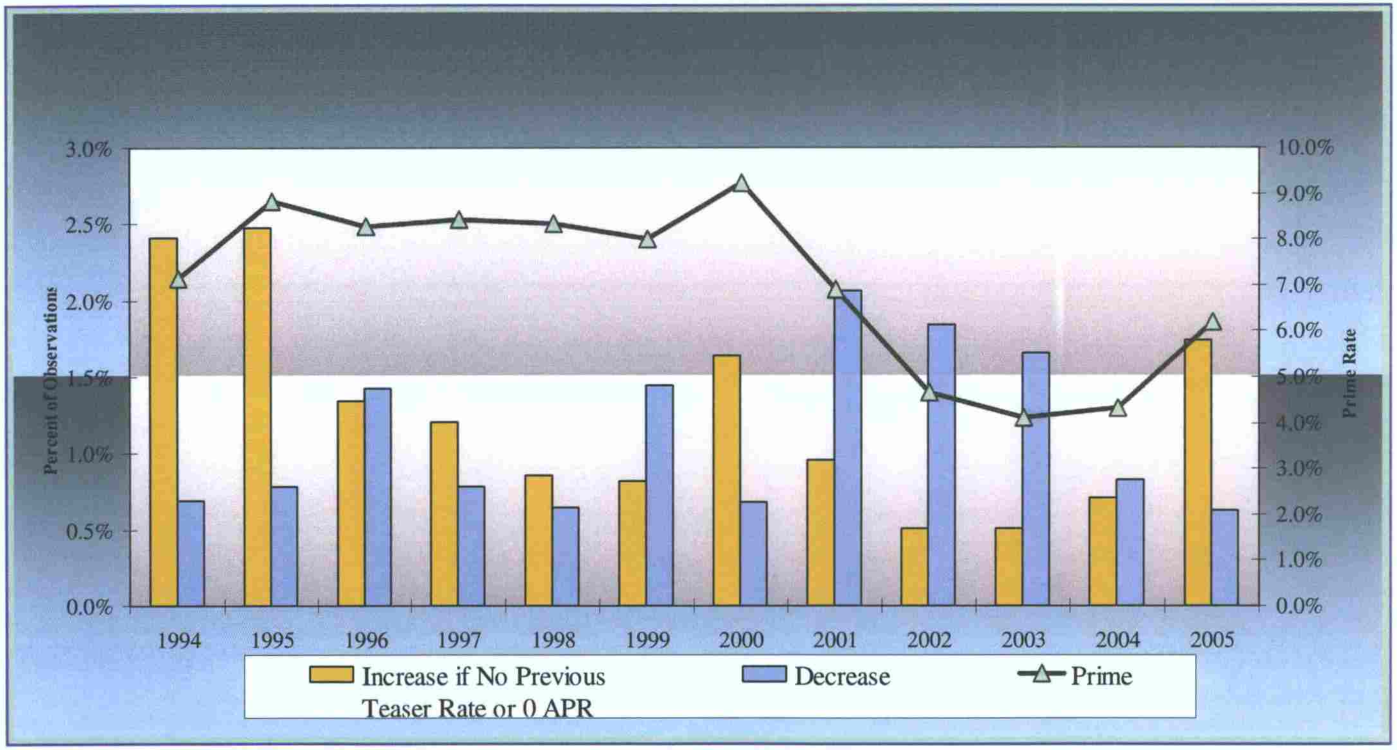
| Less Likely | More Likely | No Effect |
|---|---|---|
| Rewards | Bigger Household | Got Married |
| APRs | Younger | Got Divorced |
| Higher Income | First House | Retired |
| Homeowner | Had A Baby | Became Unemployed |

# And This Isn't A Bait & Switch

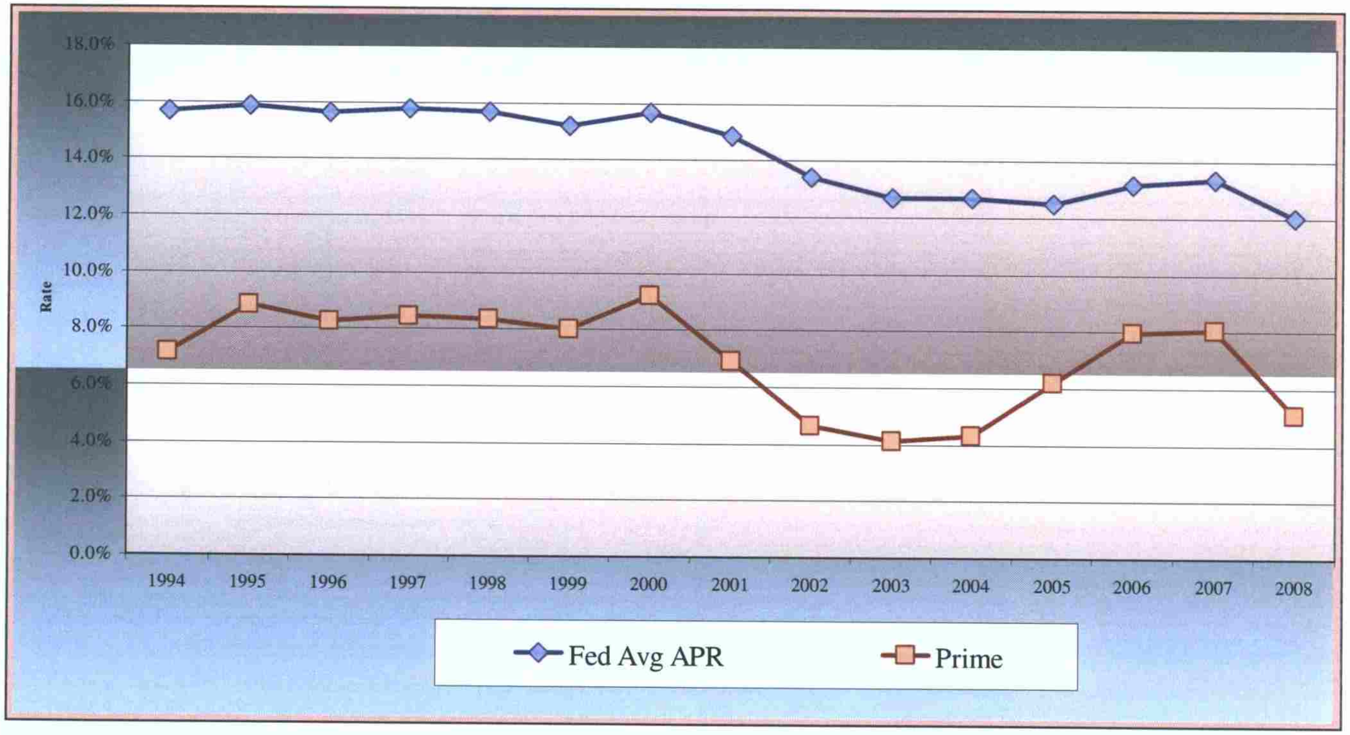
## Quarter-to-Quarter APR Changes by Type ('94-'05)



# Rates Go Up And Down
## APR Changes and Changes in the Prime Rate



# Figure 5: Credit Card APRs versus Prime 1994-2005






O'MELVENY & MYERS LLP

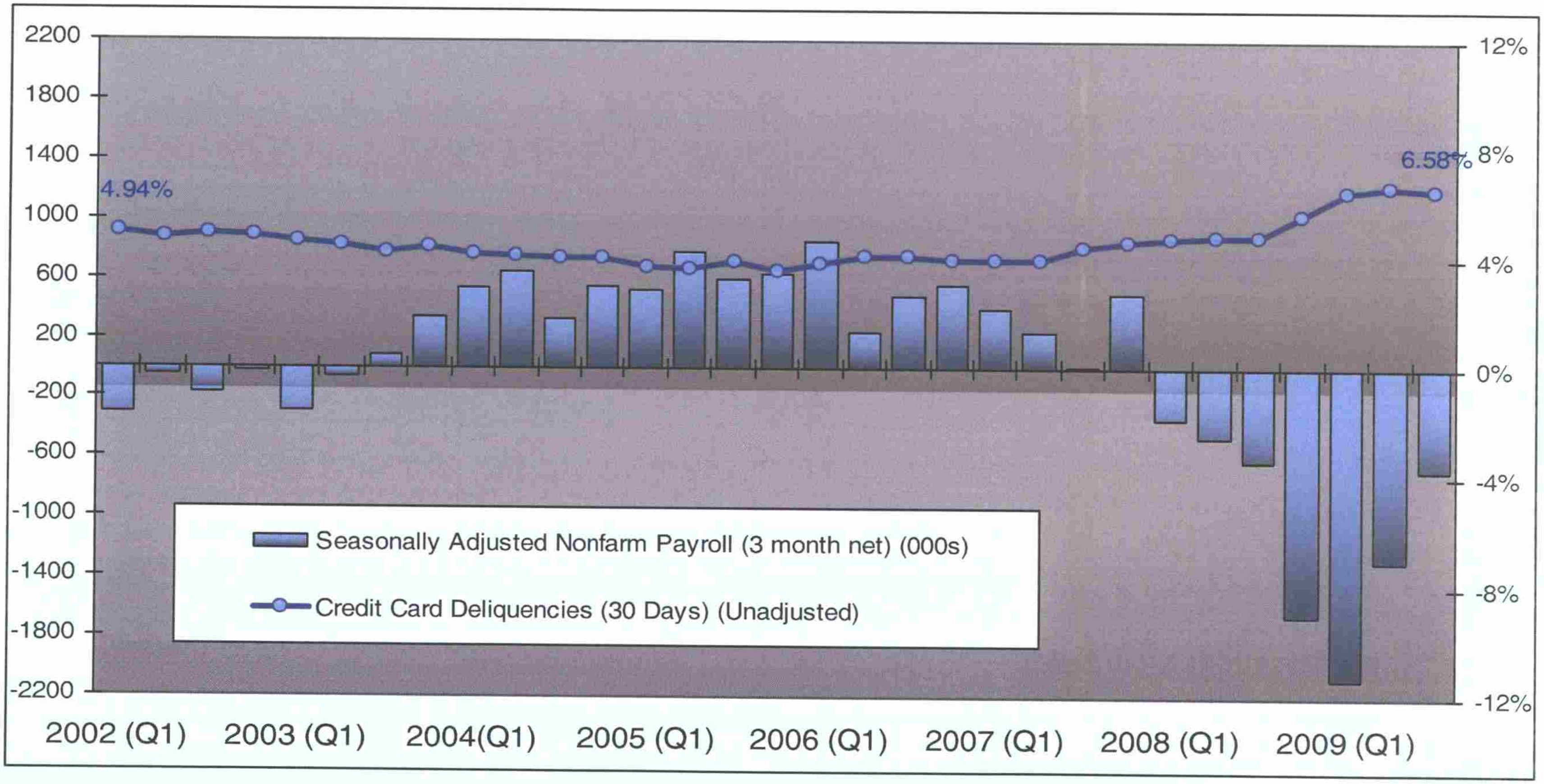
- The claims of neo-paternalists

- The empirical case against neo-paternalism

- If not a consumer protection problem, then what?

# Not Completely Unexpected

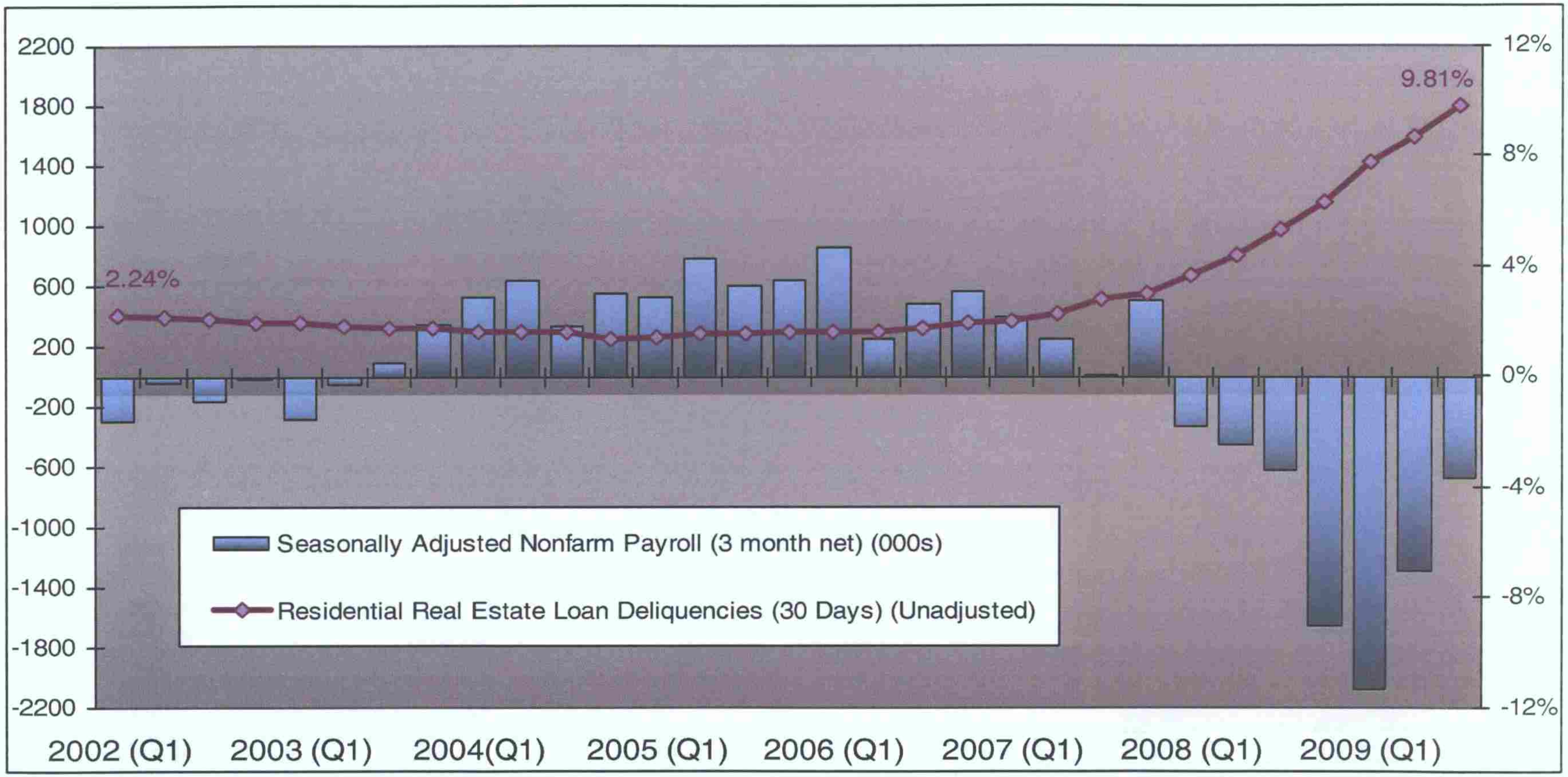
## Sustained job losses produce delinquent cardholders




Bureau of Labor Statistics, Federal Reserve

# But Not The Whole Picture

## Delinquent mortgages rose *before* employment fell

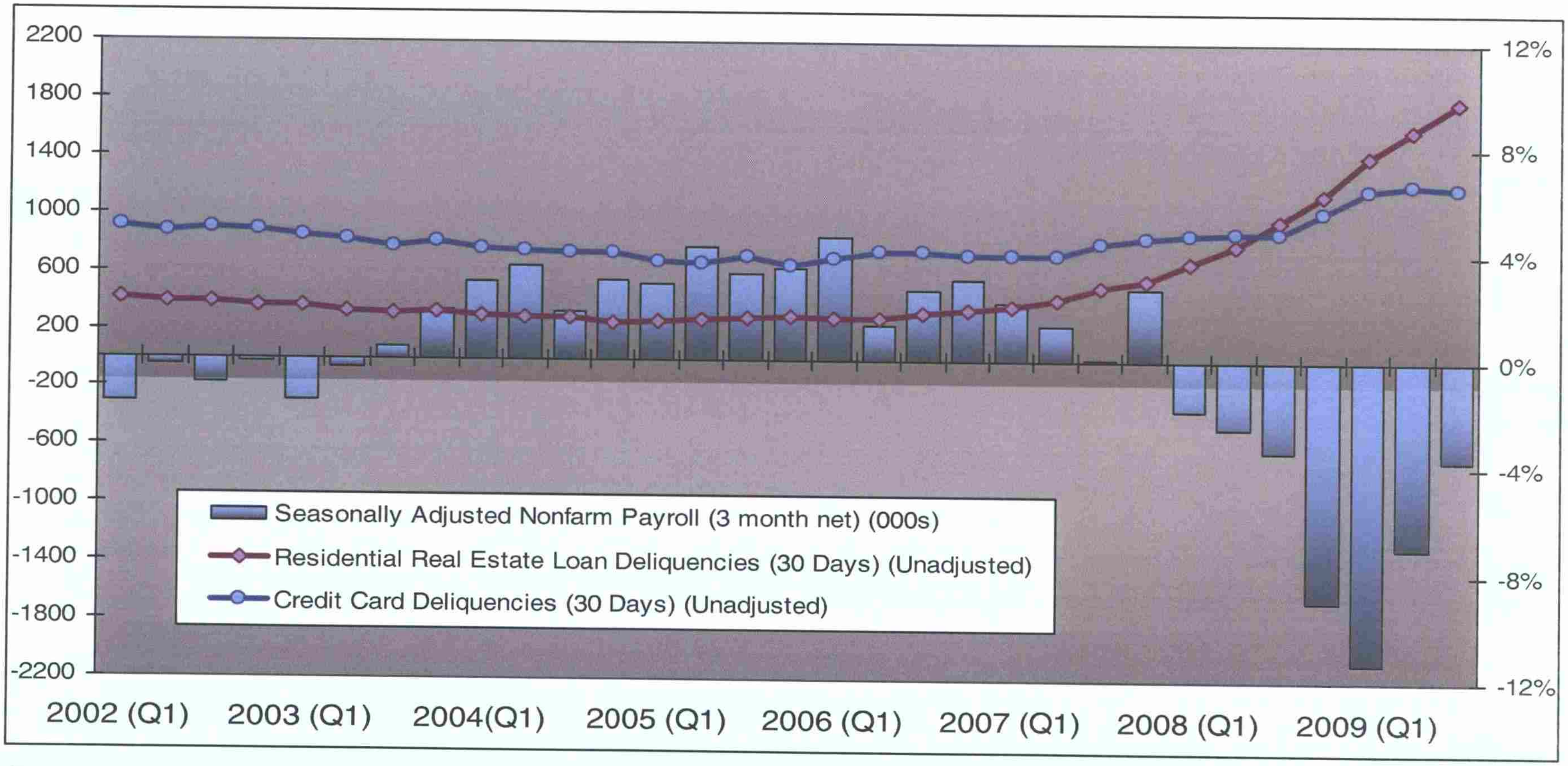



Bureau of Labor Statistics, Federal Reserve



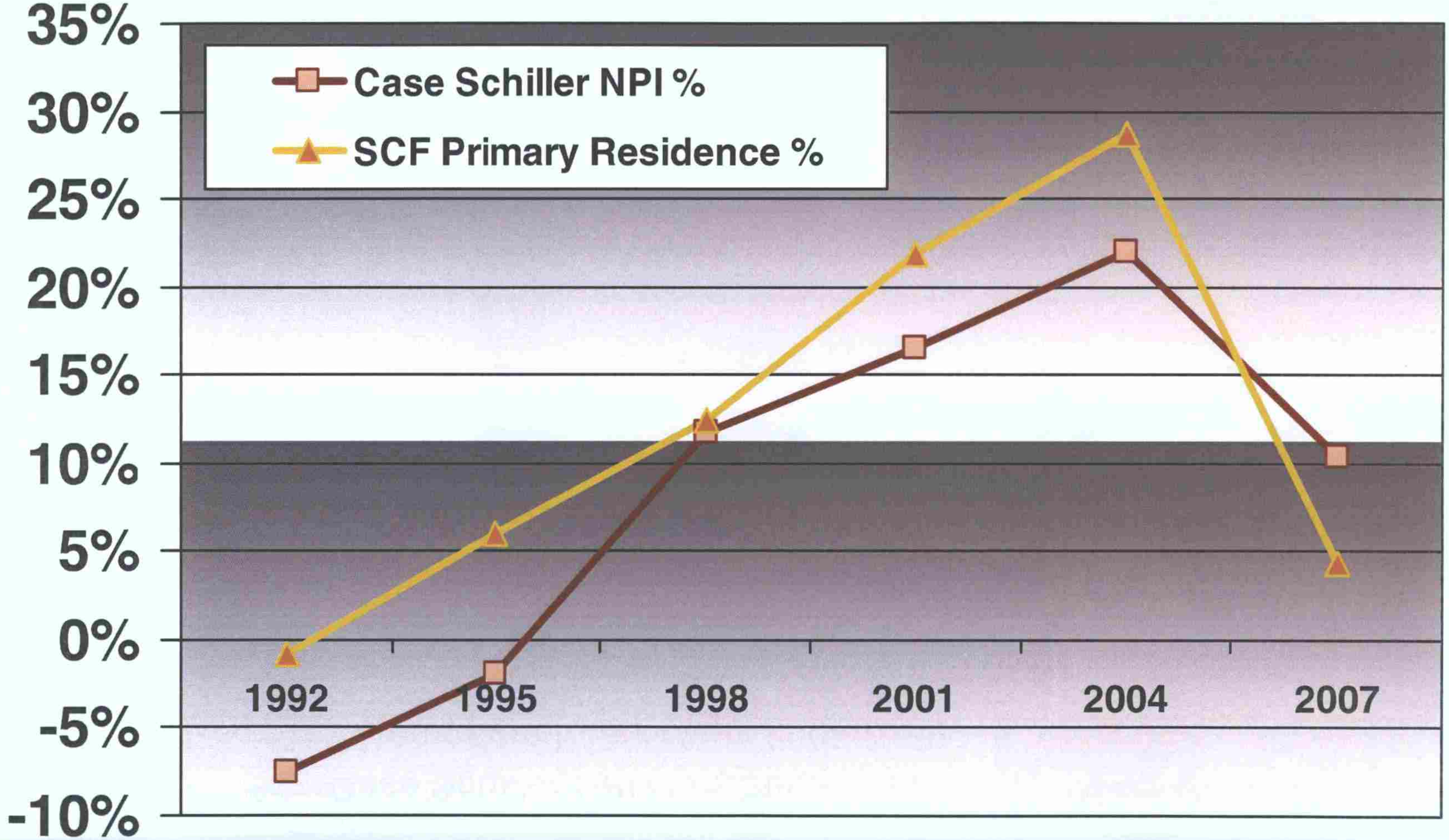
O'MELVENY & MYERS LLP

# Not Moving Together!

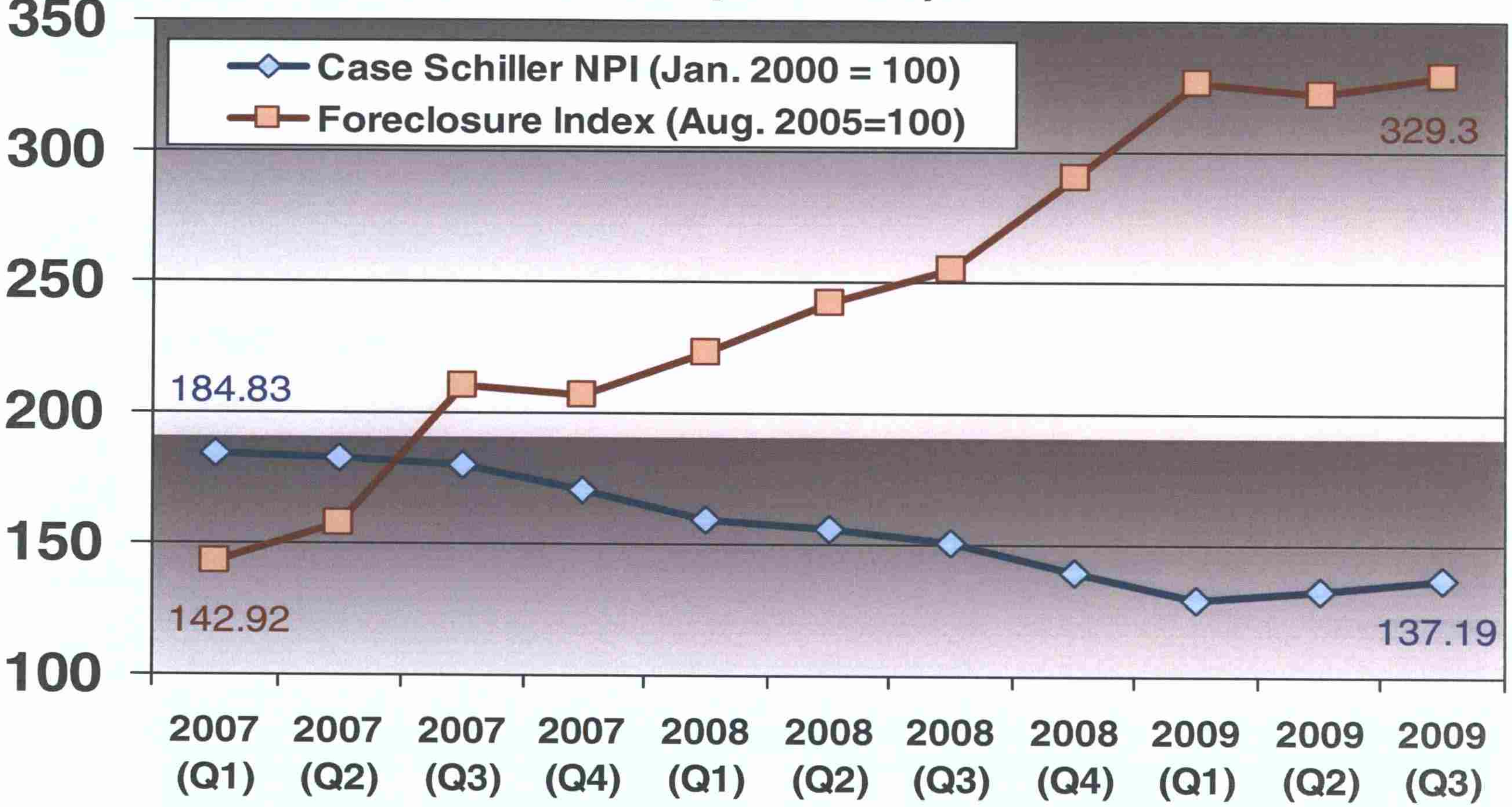



Bureau of Labor Statistics, Federal Reserve

# Home Values Rose, Stopped Rising …



# And Then Fell
## (With Predictable Consequences)



## And What Precipitated The Fall?
## (Hint: It wasn't a problem with the T&Cs)

"Low yields on ten-year treasuries encouraged money to flow into higher-yielding assets backed by, inter alia, residential mortgages. … To meet the demand for mortgage-back securities, lending standards for residential mortgages were relaxed. Agency problems between mortgage brokers who originated the loans, financial institutions who packaged and distributed them, and investors who purchased them allowed this problem to go uncorrected."

Barry Eichengreen, *The Financial Crisis and Global Policy Reforms* 23-24 (October 2009)


**These slides do not represent legal advice, and they do not offer anyone's views on this subject but my own.**

Tom Brown, Partner,

O'Melveny & Myers LLP – San Francisco, CA

tbrown@omm.com

(415) 984-8947