The Big Picture
Mean Income And Consumer Debt (1989-2007) (000s)

- Median Income
- Median Credit Card Debt
- Median Mortgage Debt

<table>
<thead>
<tr>
<th>Year</th>
<th>Median Income</th>
<th>Median Credit Card Debt</th>
<th>Median Mortgage Debt</th>
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<tbody>
<tr>
<td>1989</td>
<td>65.3</td>
<td>3</td>
<td>3</td>
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<tr>
<td>1992</td>
<td>73</td>
<td>84.1</td>
<td>3.3</td>
</tr>
<tr>
<td>1995</td>
<td>87.5</td>
<td>84.1</td>
<td>5.2</td>
</tr>
<tr>
<td>1998</td>
<td>99</td>
<td>87.5</td>
<td>4.8</td>
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<tr>
<td>2001</td>
<td>107.3</td>
<td>79.5</td>
<td>5.6</td>
</tr>
<tr>
<td>2004</td>
<td>126.2</td>
<td>77.7</td>
<td>5.6</td>
</tr>
<tr>
<td>2007</td>
<td>149</td>
<td>84.3</td>
<td>7.3</td>
</tr>
</tbody>
</table>
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

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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

Non-revolvers 43%

Revolvers 57%

Behavior After Acquisition

Don't Revolve

Revolve

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?

- 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

Source: Beales/Plache
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

<table>
<thead>
<tr>
<th>Less Likely</th>
<th>More Likely</th>
<th>No Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rewards</td>
<td>Bigger Household</td>
<td>Got Married</td>
</tr>
<tr>
<td>APRs</td>
<td>Younger</td>
<td>Got Divorced</td>
</tr>
<tr>
<td>Higher Income</td>
<td>First House</td>
<td>Retired</td>
</tr>
<tr>
<td>Homeowner</td>
<td>Had A Baby</td>
<td>Became Unemployed</td>
</tr>
</tbody>
</table>
And This Isn’t A Bait & Switch
Quarter-to-Quarter APR Changes by Type (’94-'05)

- No Change: 97.4%
- Increase if Previous Teaser Rate or 0 APR: 0.3%
- Increase if No Previous Teaser Rate or 0 APR: 1.2%
- Decrease: 1.2%
Rates Go Up And Down
APR Changes and Changes in the Prime Rate

[Bar graph showing changes in APR and Prime Rate from 1994 to 2005]

- Increase if No Previous Teaser Rate or 0 APR
- Decrease
- Prime
Figure 5: Credit Card APRs versus Prime 1994-2005
➤ 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

![Graph showing the rise in delinquent mortgages before employment fell.](image-url)
Not Moving Together!

Bureau of Labor Statistics, Federal Reserve

Seasonally Adjusted Nonfarm Payroll (3 month net) (000s)
Residential Real Estate Loan Delinquencies (30 Days) (Unadjusted)
Credit Card Delinquencies (30 Days) (Unadjusted)

Bureau of Labor Statistics, Federal Reserve
Home Values Rose, Stopped Rising ...

- Case Schiller NPI %
- SCF Primary Residence %

And Then Fell
(With Predictable Consequences)

Case Schiller NPI (Jan. 2000 = 100)
Foreclosure Index (Aug. 2005 = 100)
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.”

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

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