Regulating Consumer Credit with Over-Optimistic Borrowers

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Abstract

We quantitatively analyze consumer credit markets with behavioral consumers and default. Our model incorporates over-optimistic and rational borrower types into a standard incomplete markets with consumer bankruptcy framework. Lenders price credit endogenously, forming beliefs - type scores - about borrowers' types. Since over-optimistic borrowers incorrectly believe they have rational beliefs, lenders do not need to take strategic behavior into account when updating type scores. We find that the partial pooling of over-optimistic with rational borrowers results in spill-overs across types via interest rates, with over-optimists being cross-subsidized by rational consumers who have lower default rates. Higher interest rates lower the average debt level of realists compared to a world without over-optimists. Due to overestimating their ability to repay, over-optimists borrow too much. We evaluate three policies to address these frictions: reducing the cost of default, educating overoptimists about their true type, and increasing borrowing cost. Of the three, only the lower default costs improve the welfare of over-optimists. However, rational consumers are made worse off by that policy.