Naïve Consumers and Financial Mistakes

Financial contracts are complicated and consumers often do not grasp them in their entirety. This may lead to financial mistakes and imply significant penalty fees. We develop a quantitative theory of unsecured credit and equilibrium default in a market with sophisticated and naïve borrowers who sometimes misunderstand their contracts and make financial mistakes. When signing debt contracts, agents trade off interest rates for penalty fees. These fees make financial mistakes costly. Naïves are more prone to mistakes without internalizing this fact. They choose inefficiently high penalty fees and cross-subsidize interest rates for sophisticates in equilibrium. Our framework allows us to analyze two unexplored features of the 2009 CARD act: clearer language requirements and a limit on penalty fees in financial contracts. When assessing the welfare effects of these reforms, we disentangle the benefits of avoiding mistakes versus reduced cross-subsidization and changing equilibrium interest rates.

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