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THE “NEW” PATERNALISM IN CONSUMER CREDIT REGULATION: WHEN, WHY, AND HOW?

The paper provides a critical assessment of a new approach to consumer credit regulation called the “new” paternalism, the aim of which is to protect consumers from various biases identified within behavioral economics, while at the same time preserving the consumer’s freedom of choice. Consumer credit contracts, in particular credit cards, have evolved into an ever-growing complexity of contract terms, with a tendency to accelerate the short-term benefits and postpone the long-term costs for consumers arising out of the contract. Since both rational-choice and behavioral economics theory provide a rationale for such a contractual design, the first part of the paper confronts their predictions to argue that they are to some extent complementary and that a consumer credit regulation should not strictly align with one or the other, but rather reconcile them. The paper then discusses in more detail the features and tools of the regulatory approach of the “new” paternalism, applicable more broadly to consumer protection and encompassing three closely related ideas of libertarian, asymmetrical and weak paternalism. It also compares the theoretical foundations of the “new” paternalism to the “old” paternalism, on the one hand, which implies protecting consumers by effectively making choices instead of them, and “laissez-faire” approach, on the other hand, which entirely neglects consumers’ behavioral biases. Finally, the paper addresses the issue of which regulatory tools of the new paternalism are pertinent to the credit card market, and further considers their expected effectiveness and limitations.

Key words: Behavioral paternalism. – Consumer credit. – Credit cards. – Contract efficiency. – Behavioral law and economics.

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“Economists will and should be ignored if we continue to insist that it is axiomatic that constantly trading stocks or accumulating consumer debt or becoming a heroin addict must be optimal for the people doing these things merely because they have chosen to do it.”¹

Ted O’Donoghue and Matthew Rabin

1. INTRODUCTION

The idea of the new paternalism has emerged with the aim of providing new regulatory tools that would address the issue of behavioral biases in consumer markets, which steer consumers away from welfare-enhancing choices. Findings in behavioral economics have demonstrated that the behavior of economic agents often deviates from the predictions of the rational choice model with detrimental consequences on consumer welfare. Consumers who are prone to behavioral biases are not able to accurately estimate the costs and benefits arising out of the contract and thus are in need of some sort of regulatory guidance as to how to satisfy their preferences. Consumer credit is one of the areas where these issues are recurring, especially with respect to the use of credit cards. The aim of this paper is to critically examine to what extent the solutions offered within the regulatory approach of the new paternalism should be a basis for rethinking consumer protection in this market.

The remainder of the paper proceeds as follows. Section 2 describes the most common features of consumer credit contracts, with special emphasis on credit cards, and reviews the existing theoretical explanations within two competing frameworks of rational choice and behavioral economics. Section 3 provides an overview of recent regulatory trends in consumer protection regulation, developed under the theoretical umbrella of the new paternalism. It also discusses the advantages of the new paternalism over the two alternative regulatory approaches: the “strong” paternalism and “laissez-faire”. Section 4 considers the possibility of applying the regulatory techniques of the new paternalism to credit cards and further discusses their expected effectiveness and limitations. Section 5 concludes the paper.

¹ T. O’Donoghue, M. Rabin, “Studying Optimal Paternalism, Illustrated by a Model of Sin Taxes”, *American Economic Review* 93(2)/2003, 186.

2. CONSUMER CREDIT CONTRACTS: WHEN SHOULD BORROWERS BE PROTECTED FROM THEMSELVES?

Consumer credit (consumer debt) entails extending loans to individuals, with the purpose of purchasing “commodities or services for personal consumption or to refinance debts incurred for such purposes.”² In consumer contract law more broadly, the term *consumers* usually entails “individuals transacting in their personal capacity – outside the course of their trade, business, or profession.”³ Consumer credit is most often associated with credit provided through the use of credit cards, although it also includes other types of consumer debt, such as lines of credit and certain personal loans.⁴ Issuers of consumer credit can be merchants of goods and services bought using the line of credit, or more often the financial institutions that act as financial intermediaries. Most consumer loans represent unsecured debt which is either used for a specific purpose and repaid in installments (e.g. for purchasing a car, furniture or larger appliances), or general purpose non-revolving or revolving credit, which enables the consumer to use the funds repeatedly within the approved limit amount. An installment (non-revolving) credit also implies that both the amount borrowed and the repayment plan are specified at the time of the approval of the loan, while in the case of revolving credit the consumers are able to choose the repayment dynamics as long as they make a minimum monthly payment. Nevertheless, slow repayments increase the outstanding balance on which interest is paid, ultimately leading to greater borrowing costs.

From the economic perspective, different types of consumer credit share a common purpose of allowing consumers to smooth their consumption over time.⁵ This is consistent with the insight that people’s earnings usually follow a common cycle. They are relatively low at the

² <https://www.britannica.com/topic/consumer-credit>, last visited 5 October 2018.

³ J. Armour *et al.*, *Principles of Financial Regulation*, Oxford University Press, New York 2016, 205. The question as to who can be treated as a consumer in different regulatory contexts and different jurisdictions is beyond the scope of this paper. For the definition of a consumer, in the context of financial services in the Republic of Serbia, see Article 9(2) of the Law on the Protection of Financial Services Consumers, *Official Gazette of the Republic of Serbia*, No. 36/2011 and 139/2014. Similar definitions can be found in EU law. See Article 3(a) of the Directive 2008/48/EC [2008] OJ L133/66 on Credit Agreements for Consumers and Article 2(1) of the Directive 2011/83/EU on Consumer Rights [2011] OJ L304/64.

⁴ Mortgage (loan) contracts, although concluded by individuals acting in their personal capacity with the aim of acquiring a real estate, are usually excluded from the definition of consumer credit given that they also have an investment component.

⁵ Consumption smoothing stems from the permanent income hypothesis, which implies that individual consumption at a given point in time is determined not just by the current income but also by the expected future income. See M. Friedman, *A Theory of the Consumption Function*, Princeton University Press, Princeton 1957, 20–37.

early stage of one's career and not sufficient to satisfy consumption needs, gradually increasing over time, only to reach a stage where there is a surplus that one can save and invest, to eventually stagnate or decrease in retirement. Without borrowing, people would live much better in the middle stage of their earnings cycle than in the young age.⁶ Thus, consumer credit allows people to "borrow from future good times, to help make it through current tough times."⁷ Moreover, consumer credit helps people overcome unanticipated drops in income, such as due to job loss or unforeseeable expenses.⁸

While, at least in principle, the consumer credit is expected to increase long-term consumer welfare, extending credit to consumers entails a number of risks for the lenders, stemming from adverse selection and moral hazard problems, against which they take precautionary measures. The most obvious such measure is adjusting the interest rate for the additional default risk assumed. From a historical perspective, as tools for screening for borrowers' risk gradually advanced and heterogeneous consumers' needs became more pronounced, financial products, including consumer credit, gradually became much more sophisticated.⁹ The refinement of consumer credit went in two main directions: increasing complexity of products and product attributes, primarily fees and interest rates, and the specific intertemporal distribution of benefits and costs over the lifespan of the contract, which assumes significant cost deferral.¹⁰ These changes became particularly apparent with respect to credit card borrowing, which accounts for the greatest share of consumer borrowing.¹¹ Thus, the analysis will focus on consumer credit available through the use of credit cards.

Credit cards serve as a tool for extending credit on a revolving basis.¹² Their widespread use, which gained prominence in the 1990s, is

⁶ D. S. Evans, J. D. Wright, "The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit", *Loy. Consumer L. Rev.* 22/2009, 283.

⁷ P. M. Skiba, "Regulation of Payday Loans: Misguided", *Wash. & Lee L. Rev.* 69/2012, 1026.

⁸ D. S. Evans, J. D. Wright, "The Effect of the Consumer Financial Protection Agency Act of 2009 on Consumer Credit", *Loy. Consumer L. Rev.* 22/2009, 284.

⁹ Innovations in the sphere of risk analysis lead to a democratization of borrowing in the 1980s by significantly reducing liquidity constraints. For an overview, see D.S. Evans, J.D. Wright, 288–308.

¹⁰ O. Bar-Gill, *Seduction by Contract: Law, Economics, and Psychology in Consumer Markets*, Oxford University Press, Oxford 2012, 52.

¹¹ On retail financial services in the EU, see "Financial Products and Services", *Special Eurobarometer 446 – April 2016*, https://data.europa.eu/euodp/data/dataset/S2108_85_1_446_ENG, last visited 25 October, 2018.

¹² Credit cards are also used as a quick and efficient method of payment. While certain cardholders use them for payment purposes only, the transaction role of cards remains outside the scope of this paper.

a result of two convenient product features: “all-purpose feature” and “credit feature”.¹³ The former allows its users to acquire goods and services from various merchants who accept this payment method, while the latter enables them to postpone the payment of the outstanding balance. The simplest credit card contract has to specify the fees for issuing the card and subsequent maintaining services, the borrowing limit, the minimum monthly payment, and the annual interest rate paid on the outstanding balance.¹⁴

However, the expansion of credit card borrowing led to the growing complexity of the contract terms. Simple issuing and maintenance fees were supplemented by a number of additional fees, which can be divided into two categories: service fees and penalty fees.¹⁵ The aggregate measure of these fees is not necessarily indicative of the borrowing costs for an individual, given that not everyone relies on the same services. Moreover, some fees are contingent on the fulfillment of certain conditions, e.g. in the case of late payment fees. The size of the fees can vary as well, depending on the amount of the outstanding balance.¹⁶ Interest rates had a similar trend: in addition to the annual interest rate, which itself can follow the movement of an index, such as the consumer price index (CPI), introductory (teaser) rates and default rates, among others, have become very common.¹⁷ Finally, the complexity lies in the way balances are calculated, which has created further uncertainty regarding the total amount of interest paid. Credit card contracts sometimes include a number of auxiliary benefits for consumers, such as loyalty rewards and discounts from partner vendors, which the consumer should weight against the abovementioned costs.

In addition to increasing complexity, credit card contracts often imply a specific intertemporal distribution of benefits and costs stemming from the contract. Namely, the benefits are concentrated in the present time and the costs are deferred to the future. Although deferred costs represent the very essence of borrowing, this contract feature is

¹³ O. Bar-Gill (2012), 58.

¹⁴ The credit card industry operates at two levels: the brand level, which implies competition between different credit card brand owners, and the issuing level, which implies competition between financial institutions that contract directly with consumers. The brand level of the credit card industry, and consequently, the contracts between brand card owners and financial institutions, remain outside the scope of this paper.

¹⁵ These fees can include the following: “application fees, set-up fees, annual fees, membership fees, participation fees, cash-advance fees, balance transfer fees, foreign-currency-conversion fees, over-the-limit fees, expedited-payment or phone-payment fees, no-activity fees, fees for stop payment requests, fees for statement copies, fees for replacement cards, and wire-transfer fees.” O. Bar-Gill (2012), 66.

¹⁶ *Ibid.*

¹⁷ *Ibid.*

exacerbated through contract terms that are less salient to consumers, and which are contingent on a set of future circumstances. For instance, it is very common to charge a very low or zero introductory (teaser) interest rate, succeeded by a high annual rate following the expiration of the introductory period. In the same vein, cards issuers often charge no annual or transaction fees, even though there are fixed costs associated with credit card services, but “collect sizeable fees from consumers who either run late on their monthly payments or exceed the credit limit.”¹⁸

Economic theory offers two distinct explanations as to why these developments occurred. One explanation can be found within the rational choice model of consumer behavior, which relies on the premise that, in competitive markets, any kind of product differentiation reflects distinct cost structures or heterogeneous consumer preferences.¹⁹ The other explanation stems from behavioral economics, which acknowledges that individuals are not perfect maximizers of their utility functions, and that complex cost-deferring contract terms are used to exploit rather than to empower consumer choice. While not mutually exclusive in principle, if one allows for the existence of both rational and boundedly-rational borrowers, the two competing theories raise different concerns regarding credit card regulation, which is further discussed below.

Rational choice theory assumes that consumers have stable intertemporal preferences and that they make choices that maximize their utility, given the constraints that they face and the available information. This means that, when confronted with a large number of products to choose from, with each product having multiple dimensions, they are able to weigh each product dimension and form an aggregate value of expected costs and benefits.²⁰ In the context of credit cards, it is assumed that they do not face problems dealing with complexity – calculating the total cost arising from multiple fees and interest rates or estimating the probability of the occurrence of certain contingencies, e.g. being late with a monthly

¹⁸ *Ibid.*, 72.

¹⁹ In the context of credit cards and consumer credit more broadly, individuals are very different in terms of their intertemporal preferences, which depend on their subjective discount rates.

²⁰ Rational choice theory does not necessarily assume that consumers meticulously study all the contract attributes if high complexity generates high search costs. While it might be rational to neglect certain contract features if the costs of doing so exceed the expected benefits, rational consumers infer that less salient attributes are unfavorable to them, and thus price them efficiently. This phenomenon is known as “rational apathy”. See M.G. Faure, H.A. Luth, “Behavioural Economics in Unfair Contract Terms”, *Journal of Consumer Policy* 34(3)/2011, 340. Similarly, in the case of information asymmetry, when sellers are better informed than buyers about product attributes, buyers discount the value of the product up to the point where sellers are incentivized to unravel information. See D. Dranove, G.Z. Jin, “Quality Disclosure and Certification: Theory and Practice”, *Journal of Economic Literature* 48(4)/2010, 935–963.

payment or exceeding the credit limit. From the rational-choice perspective, the greater complexity of credit card contract features is a result of greater efficiency, which can be twofold. First, a large number of fees merely reflects various services offered by the lender, whereas not all borrowers use all services.²¹ Charging separate fees for distinct services leads to cost-efficient pricing and avoids cross-subsidization, which is unavoidable when a unique fee is charged to all borrowers.²² In other words, multiple fees and interest rates are the result of unbundling costs associated with various services. Secondly, growing complexity allows for risk-sensitive pricing. Late fees and penalties, as well as high default rates, are merely an attempt by issuers to differentiate between heterogeneous borrowers who pose different risks of not repaying the debt. Consumers who exceed their credit limit or pay late are more likely to default, which is not observable *ex ante*.²³

Rational choice theory also assumes that consumers have time-consistent intertemporal preferences. This implies that their preferences over future consumption streams exhibit a constant discount rate.²⁴ Their intertemporal impatience when comparing the present moment with the future is the same when comparing two periods in the future. Constant intertemporal impatience, i.e. constant discount rate, allows individuals to follow through with the plans they make in the present. Hence, they can accurately estimate the probability of bearing future contingent costs. In the context of credit cards, it means that, at the time of entering into a contract, consumers are able to make accurate estimates of their future credit utilization patterns: their borrowing needs and the probability that they will not be able to pay off their debt on time, which would trigger late fees and penalties. Put differently, when deciding whether to pay the outstanding credit balance and how much, consumers do not deviate from the plans they made at the time of entering into the contract. As a consequence, consumers should have no preference for immediate rewards and delayed costs, such as when low or zero introductory interest rates and annual fees are compensated by high annual (post-introductory) interest rates and late fees, as long as the total present value of the cost of borrowing remains the same. Hence, the demand side of the credit cards market cannot explain the widespread practice of postponing credit costs; however, neither can the offer side of the market. Lenders bear costs in connection with issuing credit cards and enabling transactions, which

²¹ O. Bar-Gill (2012), 76.

²² *Ibid.*

²³ *Ibid.*

²⁴ The economic model of exponentially discounted utility was developed by Samuelson (1937). See P. Samuelson, "A Note on Measurement of Utility", *Review of Economic Studies* 4/1937, 155–161.

justifies charging annual and transaction fees. Moreover, lenders themselves pay interest on funds that they use to extend credit to consumers, which covers the entire period during which the funds are used. Thus, within this framework, there is no plausible efficiency explanation for zero annual and transaction fees and introductory (teaser) interest rates. While it is true that late fees and penalties do reflect the increased costs associated with handling late payment and the increased risk of default, it remains unclear why they are used to cross-subsidize the credit card use of individuals who pay on time and do not exceed their credit limit. Thus, rational choice theory provides an unsatisfactory explanation as to why credit card contracts frequently exhibit deferred cost features.²⁵

Behavioral economics offers an alternative explanation for the increasing complexity of credit card contracts and the associated uneven intertemporal distribution of costs and benefits. Behavioral economics departs from rational choice in one major way: in addition to the accuracy of their predictions, economic models should be judged in terms of the realism of their assumptions. Two behavioral economics assumptions affect the predictions as to how consumers make decisions in terms of borrowing and how this, in turn, affects the design of credit card contracts. First, their bounded rationality, which implies limited memory, limited attention, and limited information processing capabilities, induces them to maximize the perceived total benefit arising out of the contract, which is different from the actual total benefit.²⁶ The divergence between the perceived and the actual benefits and costs occurs because consumers who face complexity neglect contract attributes and price dimensions that are not salient to them.²⁷ For instance, one can reasonably assume that credit card holders pay more attention to annual and transaction fees or introductory interest rates than late fees and penalties and long-term interest rates. In other words, salience is likely to decrease the longer the time horizon and the higher the contingency of costs stemming from the contract. Thus, bounded rationality implies that the divergence between perceived and actual costs and benefits will be greater the larger the number of the contract dimensions that consumers have to analyze and

²⁵ Rational choice theory does offer an explanation as to why interest rates can remain high in the presence of high switching costs, even though the cost of funds decreases. However, this is not a valid answer to the question as to why the intertemporal distribution of interests and fees is not aligned with the costs incurred by the lender. See D.L. Brito, P.R. Hartley, "Consumer Rationality and Credit Cards", *Journal of Political Economy* 103(2)/1995.

²⁶ Behavioral economics devotes a lot of attention to how people make decisions when facing constraints on their information-processing capacity. See A. Tversky, D. Kahneman, "Judgment Under Uncertainty: Heuristics and Biases", *Science* 185(4157)/1974.

²⁷ O. Bar-Gill (2012), 9.

the more deferred and contingent the costs are. Lenders, on the contrary, are able to profit from consumer misperception, since they are able to artificially increase the demand for their products without increasing actual benefits or decreasing actual costs.²⁸ Hence, they are incentivized to design a multi-dimensional cost structure in which high costs lie with shrouded attributes.²⁹

The second behavioral economics assumption, which provides an explanation for the deferred costs feature of the credit card contract, is a self-control problem. A number of behavioral economics studies have shown that, contrary to the rational choice model, consumers exhibit short-run impatience which induces instantaneous gratification. Short-run impatience (also known as present bias or quasi-hyperbolic discounting) means that individuals behave as if their discount rate is higher when comparing the present moment to the future than when comparing two periods in the future.³⁰ This leads them into preference reversals or time-inconsistency, i.e. their behavior deviates from their long-run intentions.³¹ In other words, when the time of gratification arrives, consumers utility arising out of it is higher than what the long-term preferences would have implied. This bears a number of implications for the credit card market. Credit card contracts have two main price components. One price component reflects the fixed costs that a lender incurs to issue the credit card and provide related services and it is usually paid upfront, in the form of annual fees. The other price component is variable and depends on the future utilization pattern of the cardholder. The more a card is used i.e. the greater the outstanding balance is or the longer the consumers carry the balance, the larger the total amount of interest due is. The variable price component is, thus, paid in the form of long-term interest, and late fees and penalties. At the time of the conclusion of the contract, consumers with time-inconsistent preferences will tend to underestimate how much they will borrow and for how long they will carry the balance, which leads to the underestimation of the variable price component. As a consequence, the contractual design of credit cards

²⁸ *Ibid.*, 10.

²⁹ Shrouding high price components and cross-subsidizing more salient ones can be a profitable strategy even in highly competitive markets. See X. Gabaix, D. Laibson, “Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets”, *The Quarterly Journal of Economics* 121(2)/2006.

³⁰ See D. Laibson, “Golden Eggs and Hyperbolic Discounting”, *The Quarterly Journal of Economics* 112(2)/1997.

³¹ Deviation from long-run intentions can take the form of over-consuming leisure goods (when rewards are immediate and costs are delayed) or under-consuming investment goods (when costs are immediate and rewards are delayed). Credit cards have all the features of leisure goods. See S. DellaVigna, U. Malmendier, “Contract Design and Self-Control: Theory and Evidence”, *The Quarterly Journal of Economics* 119(2)/2004, 377.

“targets consumer misperception of future consumption and underestimation of the renewal probability.”³² The issuers, thus, typically require no annual fee, which is otherwise paid upfront, and charge interest rates above marginal costs.³³ One could argue that the deferred cost structure is not so harmful to consumers, as long as they “debias” their beliefs regarding the actual cost of borrowing *ex post*, after having experienced paying late fees and penalties or seeing the pace at which their outstanding balance grows, due to making only the minimum payment. In other words, once they become aware of it, they could cut their expenses in the current period in order to decrease their outstanding balance and accruing interest. However, the question is how long it will take them to update their beliefs and how much interest and fees are accumulated by that time, which, in turn, could prevent them from paying off the outstanding balance for a long time, even if they “tighten their belts”. Moreover, it is also likely that they will run into self-control issues in several consecutive periods, every time underestimating their future consumption.

In sum, behavioral economics predictions with respect to the credit card market entail some serious efficiency considerations. Subsidized annual fees and introductory rates at the expense of long-term interest rates and late fees cause consumers to underestimate the total costs of borrowing. This might lead them into excessive borrowing and financial distress. Hence, the question arises as to how the regulation of credit card borrowing could improve the market outcomes.

3. THE “NEW PATERNALISM” IN CONSUMER PROTECTION: WHY DID CONVENTIONAL REGULATORY APPROACHES FAIL?

Behavioral biases are not specific to the consumer credit market. Quite the contrary, an increasing number of studies of financial retail markets is bringing evidence that consumer behavior departs from the predictions of the rational model. The evidence is even more abundant in more general consumer markets. “Behavioral failures” in these markets

³² *Ibid.*, 353.

³³ In accordance with behavioral economics predictions, a recent empirical study provides evidence that consumer present bias increases the probability of borrowing. See S. Meier, C. Sprenger, “Present-biased preferences and credit card borrowing”, *American Economic Journal: Applied Economics* 2(1)/2010. While the self-control problem might be the most pronounced, there are two other alternative explanations within behavioral economics that explain the deferred cost feature of credit card contracts: “underestimation of contingencies bearing future hardship” and “forgetfulness”. O. Bar-Gill, “Seduction by Plastic”, *Nw. U. L. Rev* 98/2004, 1400–1401.

have led to some normative stances that regulatory intervention should enhance consumer welfare by protecting consumers from their own mistakes and misperceptions, with a minimal cost of the regulatory intervention.³⁴ The “new” paternalism, which incorporates closely related ideas of asymmetric, libertarian and weak paternalism, has been built on criticism of a “laissez-faire” approach to regulation, which ignores behavioral biases, and also strong paternalism, which constrains the choices of both rational and irrational individuals.³⁵

The starting point in rethinking consumer market regulation should be another look at the parties’ autonomy of will in light of behavioral biases. The freedom of contract paradigm relies on the assumption that, in the absence of a market failure, parties who enter into a contract voluntarily will both be made better off.³⁶ Not only the contract itself but also each contractual clause would maximize the overall welfare of the contracting parties, given that even clauses that are unfavorable to one party can be priced accordingly.³⁷ The minimal room for regulatory intervention is limited to cases of pronounced information asymmetries between the parties and the externalities that their contractual relationship can produce for third parties. While the freedom of contract argument makes a strong claim against more pervasive regulatory intervention, it is only plausible to the extent to which the parties to the contract accurately estimate the costs and benefits arising out of the contract and the particular clauses. However, behavioral economics findings indicate that consumer predictions of the welfare effects of a contract sometimes fall short, even if they are provided the necessary information, i.e. even in the absence of information asymmetry. The misperception of costs and benefits of certain contract attributes, due to behavioral biases, steers consumers away from welfare maximizing behavior and undermines the value of contractual freedom as the ultimate welfare-promoting principle. Hence, the “laissez-faire” approach to consumer protection, which justifies regulatory intervention only in the case of certain market failures, needs to be revisited.

On the other end of the regulatory spectrum lies the idea that regulatory intervention is justified, even when it is against the consumer’s

³⁴ “Regulation that “treads on consumer sovereignty by forcing, or preventing, choices for the individual’s own good,” is denoted as paternalistic regulation. The notion of helping individuals make better choices is what distinguishes paternalism from the other two types of regulation: regulation aimed at redistribution, and regulation aimed at countervailing externalities. C. Camerer *et al.*, “Regulation for Conservatives: Behavioral Economics and the Case for Asymmetric Paternalism”, *University of Pennsylvania Law Review* 151(3)/2003, 1211.

³⁵ R. Kapeliushnikov, “Behavioral Economics and the ‘New’ Paternalism”, *Russian Journal of Economics* 1(1)/2015, 82.

³⁶ O. Bar-Gill (2004), 1415.

³⁷ *Ibid.*

will, for instance, by *de facto* taking away the freedom of choice if “an individual is assumed incapable of identifying her own true interests.”³⁸ This “hard” version of consumer paternalism, which dates well before the emergence of behavioral economics as a discipline (also denoted as “old paternalism”), implies that a paternalistic state or regulator is invited to define instead of individuals “what their true welfare is.”³⁹ By entirely ignoring consumer preferences, this regulatory approach encounters three serious limitations. The first limitation stems from the fact that this sort of regulatory intervention targets the entire population of consumers, who can have heterogeneous preferences. What might seem to be a welfare-decreasing behavior for a few or even the majority within a population might not hold true for all. Thus “hard” paternalism runs into the problem of protecting boundedly rational people at the expense of others. Second, the question arises as to why the regulator should have the final say in defining what the true interest of consumers is and how this true interest is articulated. For instance, even if excessive borrowing or smoking seems to produce detrimental consequences in the long run, it is hardly justifiable to ban such behavior. Third, government officials may also be prone to errors. Thus, allowing a consumer to opt out of some presupposed choices, made by regulators, can serve as a safeguard against such erroneous solutions.⁴⁰

The new regulatory approach to consumer protection, based on behavioral economics findings, attempts to reconcile the two approaches by admitting that consumer choices are not always aligned with their long-term welfare, but at the same time, relying on consumers’ preferences as a normative standard. Put differently, “the ‘new’ paternalism “is aimed at helping people achieve what they want” or what they would have achieved themselves if not constrained by cognitive and other behavioral limitations.”⁴¹ Three closely related ideas have developed along this line of reasoning: asymmetric paternalism,⁴² libertarian paternalism,⁴³ and weak paternalism.⁴⁴ Asymmetric paternalism implies that regulations should “create large benefits for those who make errors, while imposing little or no harm on those who are fully rational.”⁴⁵ The idea of asymmetric

³⁸ R. Kapeliushnikov, 89.

³⁹ *Ibid.*, 90.

⁴⁰ C. R. Sunstein, “Boundedly Rational Borrowing”, *U. Chi. L. Rev.* 73/2006, 255.

⁴¹ R. Kapeliushnikov, 90.

⁴² See C. Camerer *et al.*

⁴³ See C. R. Sunstein, R. H. Thaler, “Libertarian Paternalism Is Not an Oxymoron”, *The University of Chicago Law Review* 70(4)/2003.

⁴⁴ See C. Jolls, C. R. Sunstein, “Debiasing through Law”, *The Journal of Legal Studies* 35(1)/2006.

⁴⁵ C. Camerer *et al.*, 1212.

paternalism is built on the premise that mistakes identified within behavioral economics, while being common or prevalent, are not universal. Thus, it is undesirable to put an unnecessary burden on those individuals who are behaving in a way that enhances their welfare.⁴⁶ One typical example of asymmetric paternalism is the cooling-off period, which imposes a waiting period before making a buying decision, in order to help people overcome their self-control problems. The cooling-off period may also help people with bounded rationality to the extent that postponing a decision allows them to examine certain contract terms in greater detail.

Similarly, libertarian paternalism attempts to “steer people’s choices in welfare-promoting directions without eliminating freedom of choice.”⁴⁷ The idea behind it is that the way a choice is presented can have an important impact on the choice made. This is known as a nudge – “a choice architecture that alters people’s behavior in a predictable way without forbidding any options or significantly changing their economic incentives”.⁴⁸ The core example is default rules, used in the sense of preselected options and rules that are applicable unless individuals choose otherwise, i.e. when no alternative is specified by them.⁴⁹ The idea is that defaults can move the individual’s choice in the direction that will improve their well-being while at the same time allowing people to opt out. Those individuals whose preferences do not align with the default option must make a conscious decision to choose a different set of rules. It has been shown in different areas that people tend to stay with the default option, which is presumably in their best interest.⁵⁰ A number of reasons explains why the defaults are “sticky”: the power of suggestion, inertia, endowment effect, and ill-informed preferences.⁵¹ Since opting out, at least in principle, “imposes trivial costs on those who seek to depart from the planner’s preferred option,”⁵² there is a considerable overlap between libertarian and asymmetric paternalism.

⁴⁶ *Ibid.*, 1214.

⁴⁷ C. R. Sunstein, R. H. Thaler (2003), 1159.

⁴⁸ R. H. Thaler, C.R. Sunstein, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Penguin Books, New York 2009, 6.

⁴⁹ This use of the term *default* is in line with the terminology endorsed in behavioral economics literature. It has no connection to *default* in the sense of a failure to fulfill an obligation such as to repay a loan.

⁵⁰ An area where default rules have led to tremendous success is automatic saving plans, which significantly increased savings rates. See, e.g., J.J. Choi *et al.*, “Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance”, *Tax Policy and the Economy* 16/2002.

⁵¹ See C. R. Sunstein, R. H. Thaler (2003), 21–24.

⁵² *Ibid.*, 4.

Finally, the third, and the least intrusive form of paternalism is called “debiasing through law” or weak paternalism.⁵³ It advocates that the best way to respond to problems of bounded rationality is “not by insulating legal outcomes from its effects, but instead by operating directly on the boundedly rational behavior and attempting to help people either to reduce or to eliminate it.”⁵⁴ The problem of limited consumer understanding and making welfare-decreasing choices does not merely reflect a lack of information, but rather how individuals interpret available information and to what extent it appears relevant to them. In other words, if consumers tend to underestimate the probability of certain events occurring, either due to optimism bias or present bias, risk warnings or information on negative consequences linked to these events is simply neglected. Weak paternalism tries to take advantage of available empirical studies on how to “debias” people from the effects of bounded rationality and impose these debiasing strategies as a legal obligation on the other contracting party. For example, it has been shown that people are more likely to take certain risks seriously if the warnings are “making an occurrence available to consumers by exposing them to a concrete instance of the occurrence” (debiasing through the availability heuristic).⁵⁵ Similarly, consumers are more likely to appreciate the risks at stake if the information is framed in a way that particularly stresses the potential negative consequences rather than just allowing the other contracting party to choose the way information is presented (debiasing through framing).⁵⁶ This is particularly important if the other contracting party is providing certain information in response to legal requirements, while her interests would incentivize her to hide or minimize the risk perceived by consumers. In sum, weak paternalism, unlike libertarian paternalism, does not create a presumed consumer choice such as through defaults, and, therefore, interferes even less with the consumer freedom of contracting. However, to the extent that framing always entails leaving out certain information, it can de facto produce an effect of a nudge.

While the “new” paternalism in all its forms, which are not always easily differentiable, introduces certain advantages over more conventional forms of consumer market regulation, there is a number of caveats associated with its implementation. First, given their persuasive powers, nudges and other types of subtle influences on consumer behavior are not as benign as advertised. If defaults are suggestive enough to actually interfere with consumer preferences or they change the incentives of individuals, then the freedom of choice is threatened in a similar manner

⁵³ See C. Jolls, C.R. Sunstein.

⁵⁴ *Ibid.*, 200.

⁵⁵ *Ibid.*, 210.

⁵⁶ *Ibid.*, 216.

as in the case of “strong” paternalism. Secondly, empirical evidence on debiasing strategies and their effects is still scarce as compared to the number of consumer markets in which they are applicable. As a consequence, the debiasing strategy that proved to be a success in one context can turn into a failure in a different one. Finally, the ideas of the new paternalism, while providing solid guidance, are still in many aspects insufficiently specific for practical implementation, as will be discussed in the context of the credit card market in the next section.

4. USE DISCLOSURES AND BEYOND: HOW TO TAILOR NEW PATERNALISM TO THE CREDIT CARD MARKET?

Recent trends have revealed that credit card contracts are becoming more and more complex, with a tendency to accelerate short-term benefits and defer long-term costs. While rational choice theory accounts for why an increase in complexity has occurred, it falls short of explaining why the costs tend to be concentrated along the non-salient and long-term contract dimensions. Although behavioral economics offers a somewhat more plausible explanation, it also raises the concern that complicated cost structure and cost deferral can result in excessive borrowing. The question is whether regulatory intervention can steer consumer choices in the welfare-enhancing direction and what sort of regulation is deemed the most cost-effective.

From the point of view of a “laissez-faire” approach, one of the sources of potential welfare loss is insufficient or inadequate information about product attributes. Thus, the regulator should extend a helping hand in the form of mandatory disclosure of information. However, this least-intrusive method of regulatory intervention proves to be ineffective since mandating more information merely aggravates the “information overload”, which is the cause of cognitive biases. For instance, a requirement that lenders specify every single fee they charge, together with all the details regarding the methodology when and how these fees are calculated, and various other contract dimensions, can affect the consumers’ ability to select and process the most relevant information. The cognitive shortcuts that consumers use when dealing with complexity might lead them to the neglecting of some important contract attributes. The idea that “more-is-not-the-merrier” when it comes to information disclosure is reinforced by the fact that it is in the interest of the lender that “important facts remain hidden, buried in fine print, or unintelligible”.⁵⁷ This is the reason why it has become prevalent in different jurisdictions worldwide to require lenders to disclose an aggregate measure of the cost

⁵⁷ C. R. Sunstein, 260.

of borrowing (annual percentage rate – APR). However, such a regulatory solution is not without other caveats. It is easily conceivable that some contingent sources of income for the lender, such as late fees, would remain outside the scope of the APR regulation, and that, consequently, the lender would exploit this loophole at the expense of boundedly rational consumers.⁵⁸ Moreover, one of the reasons why the complexity of the contract design leads to underestimation of costs is that many of the services offered by the lender are either optional or contingent on the occurrence of certain events in the future, which are hard to predict at the time of entering into the contract. This makes it difficult for any sort of aggregate measure to realistically capture the total cost of borrowing for all individuals. Finally, the borrower's misperception of the total cost arising out of the contract is also related to the present bias, which leads to the underestimation of the costs that are dependent on the utilization patterns. If the borrower underestimates how much she will borrow in the future and how long she will carry the balance, even the most comprehensive APR that focuses on product attributes would not lead to an efficient outcome.⁵⁹ For the same reason, any type of generic warning against excessive borrowing is unlikely to produce an effect since it would not help borrowers to overcome their underestimation bias.⁶⁰

However, the described limitations do not justify resorting to the legal tools available under the regulatory umbrella of the “old” paternalism. One such tool would be capping long-term interest rates in order to limit borrowers' indebtedness. An obvious consequence of price controls would be an inefficient reduction of the credit supply. Not only is such a measure likely to affect both rational and boundedly rational borrowers, but it would primarily target the riskiest borrowers to whom extending credit would no longer be profitable. Since the riskiest borrowers are often the ones with the lowest income, price controls would also restrain the credit supply to people who need it the most. Another unintended consequence of this sort of regulatory intervention would be creating perverse incentives for lenders to extend credit to consumers through other unregulated types of consumer credit, or alternatively, to raise another price dimension which is not subject to price control. Banning certain fees that aggravate consumers' misperception about the costs of borrowing is also likely to encourage an increase in another price component.

⁵⁸ *Ibid.*

⁵⁹ Economic theory provides an explanation as to why the lender does not have an incentive to voluntarily provide the borrower with the product-use information as opposed to product-attribute information. See O. Bar-Gill, O. Board, “Product-Use Information and the Limits of Voluntary Disclosure”, *American Law and Economics Review* 14(1)/2012, 243.

⁶⁰ O. Bar-Gill (2004), 1418.

Hence, one should search for a solution among policy tools of the “new” paternalism with the aim of steering consumers choice in the welfare-enhancing direction without creating an unnecessary burden for rational individuals who are not prone to behavioral biases. Several regulatory interventions that have been suggested in literature fall within “weak” paternalism or the idea of debiasing through law. It has been proposed to extend the mandatory disclosure regulation to cover both information on product attributes and product use.⁶¹ For example, the regulation can impose on lenders the obligation to disclose the number of late payments or the frequency of exceeding the credit limit by an average consumer in one year, or the average amount that a consumer pays in late fees and over-the-limit fees in one year.⁶² The product-use information allows a consumer to make more accurate estimates of the actual costs of borrowing and, thus, to be in a better position when deciding whether to enter into a contract in the first place and, more importantly, how much debt to repay during the current period. This regulatory tool represents an example of debiasing through availability since the incidence of an occurrence such as late fees or over-the-limit fees becomes available by exposing consumers to past data. Moreover, the product-use disclosure is also likely to reintroduce more efficient distribution of costs and benefits across the time during which the credit is used, given that lenders are not able to artificially inflate demand by deferring costs. In addition to average-use information for the population as a whole or a given group, regulators can require lenders to make individual-use information available.⁶³ Some evidence suggests that individual-use information, when available, is more persuasive, given that consumers suffer from optimism bias, which leads them into thinking that the average statistics is not pertinent to them.⁶⁴ While attenuating consumers’ misperception about the true cost of borrowing, the disclosure of the product-use information does not resolve the problem of complexity of the cost structure nor does it directly target the self-control bias. Moreover, there is a danger that lenders will try to undermine these disclosures by making other contract features, such as teaser rates, more salient. Another debiasing-through-law policy option is the “minimum payment nudge”. Lenders can be required to issue a warning on a monthly bill regarding how much time it would take the consumer to pay off the debt entirely if she continues to pay only the minimum payment and information on how much she could save with a faster repayment plan.⁶⁵ The minimum

⁶¹ O. Bar-Gill, O. Board, 255–263.

⁶² *Ibid.*, 259.

⁶³ *Ibid.*, 260–262.

⁶⁴ *Ibid.*, 261.

⁶⁵ O. Bar-Gill (2012), 111.

payment nudge was introduced by the Card Act in the US in 2009.⁶⁶ A recent empirical study suggests that it has led to consumer savings.⁶⁷

Finally, a number of proposed regulatory tools can be qualified as nudges and defaults. One default can be established by imposing the obligation on credit card issuers to first offer to consumers a simple standardized contract, such as the one with a one-dimensional price, and allow consumers to subsequently opt-in for credit card products with more complex attributes.⁶⁸ Whilst the idea of a “plain vanilla” credit card product seems appealing at first, there are considerable practical caveats to its effective use. As long as the lender is allowed to offer other contract alternatives to a consumer, which of the contracts is offered first seems to bear little importance.⁶⁹ Another implicit default option would be to unbundle the transaction and credit functions of the credit card, where the consumer would use only a debit card for transactions, which protects her from paying interest due to forgetfulness or procrastination.⁷⁰ The effect of this regulatory option is most likely negligible, given that the interest paid due to forgetfulness or procrastination is a tiny portion of the total interest paid due to issues of self-control. Lastly, it has been suggested to introduce the automatic deduction of credit card payments from a specified checking account.⁷¹ This default option would also provide credit card users with the possibility to opt out at the time of the conclusion of the contract, or at the later stage. While the automatic deduction plan seems like an effective commitment device for those with self-control issues, it is an open question whether consumers who have sufficient funds in one of their checking accounts use the expensive credit card borrowing in the first place.

5. CONCLUSION

This paper has examined the possibility of applying recent normative prescriptions of behavioral economics to consumer credit

⁶⁶ The Credit Card Accountability Responsibility and Disclosure Act of 2009, *Public Law 111* – May 22, 2009.

⁶⁷ See S. Agarwal *et al.*, “Regulating Consumer Financial Products: Evidence from Credit Cards”, *The Quarterly Journal of Economics* 130(1)/2014, 35–42.

⁶⁸ J. D. Wright, D. H. Ginsburg, “Behavioral Law and Economics: Its Origins, Fatal Flaws, and Implications for Liberty”, *Nw. UL Rev.* 106/2012, 1057.

⁶⁹ In the US, The Card Act from 2009 requires opting in for over-the-limit fees. Otherwise lenders can choose between declining a transaction that surpasses the limit and charging no fees. According to Agarwal *et al.* (2015), over-the-limit fees fell considerably due to this requirement. See S. Agarwal *et al.*, 25.

⁷⁰ C. R. Sunstein, 266.

⁷¹ *Ibid.*

regulation, with a special emphasis on credit card contracts. It shows that both rational choice and behavior economics theory can offer complementary explanations for some of the defining features credit card contracts have developed over time: increasing complexity and a specific intertemporal distribution of costs and benefits. While heterogeneous consumer preferences and risk-sensitive pricing could credibly explain some of the contract complexities, the strategy of shrouding high costs along non-salient and long-term contract dimensions, in line with behavioral economics predictions, appears equally convincing. Moreover, behavioral economics literature has made a strong case as to why self-control problems prompted by a deferred cost structure can lead some but not all consumers to borrow excessively.

These findings suggest that the regulatory approach should attempt to reconcile the two theoretical frameworks by guiding the behavior of boundedly rational consumers in a welfare-enhancing direction, while at the same time preserving the freedom of choice of rational individuals who are able to choose the best means to their ends. The argumentation provided in the theory of “new” paternalism offers a good starting point for questioning the conventional regulatory approaches to consumer protection: principles of “laissez-faire” and the “old” paternalism. The paper recognizes that, despite the well-founded arguments as to why the “new” paternalism should be embraced over the other two regulatory alternatives on an abstract level, there are still considerable challenges *vis-à-vis* its implementation in the credit card market.

None of the solutions proposed in literature, which range from debiasing through law to nudges and defaults, are able to address the issues of bounded rationality and self-control in a comprehensive manner. The paper discusses why standard APR disclosures prove to be ineffective given the optional character of certain fees and different credit card utilization patterns. The product-use disclosure suggested in the new paternalism literature, while making consumers better aware of the long-term hidden costs, is not able to help them to overcome the self-control bias. The minimum payment nudge also attenuates this bias only indirectly, by stressing the long-term savings from paying off the outstanding balance in a timely manner. Some of the default options analyzed in the paper, such the automatic deduction plan, appear more promising as they offer consumers a commitment device to follow through with their long-term repayment plans, but they are limited to situations in which the consumer has sufficient funds in her checking account.

For these reasons, the paper is cautious with respect to policy prescriptions, which would require future law and economics scholarship to address several questions. First, more empirical analysis is needed to assess to what extent consumers are sensitive to nudges and debiasing

techniques in financial markets, and more specifically in the credit card market. Second, seemingly benign, the “new” paternalism raises the question of the costs of regulatory intervention: both direct, i.e. the burden put on financial intermediaries and financial authorities that monitor them, and indirect, in terms of a danger of creating rules that would affect the preferences and incentives of rational consumers. Finally, the challenge lies in designing detailed rules that would effectively transpose the abstract principles of the “new” paternalism into readily applicable regulations. The first step towards this aim is to review in greater detail the regulatory solutions in jurisdictions that have already embraced some of the ideas of the “new” paternalism.

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