



The impact of wealth on financial mistakes: Evidence from credit card non-payment

Barry Scholnick^{a,1}, Nadia Massoud^{b,*}, Anthony Saunders^c

^a School of Business, University of Alberta, Edmonton, Canada

^b Schulich School of Business, York University, Toronto, Canada

^c Stern School of Business, New York University, NY, NY, United States

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ABSTRACT

Recent research finds that poorer individuals make financial mistakes when the decisions are difficult and rare. We examine who makes financial mistakes involving decisions that are easier and more frequent – specifically, the inadvertent failure to pay monthly credit card balances when sufficient funds are available. On the one hand poorer individuals may make such mistakes because of lower levels of financial literacy. Alternatively, richer individuals may make such mistakes because of the relatively lower costs to them of such mistakes. We examine this question using confidential individual credit card statement data, with over a million data points. Our results show that poorer individuals are more likely to make these mistakes, even after controlling for education.

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1. Introduction

Following the events of the recent financial crisis, policymakers have shown significant concern regarding the general public's limited knowledge of basic financial concepts, and the tools they need to make appropriate financial decisions. This concern has resulted, for example, in the US setting up the Consumer Financial

Protection Bureau. US President Barack Obama has described one of the goals of this new Bureau as being to “...ensure that folks aren't unwittingly caught by ... fees” (White House Press Release, September 17, 2010). An important policy issue for agencies such as this, therefore, is to isolate which types of individual (based on characteristics such as income/wealth or education) are more likely to make financial mistakes resulting in unnecessary fees.

Recent research has examined the impact of wealth/income on financial mistakes in a variety of contexts. In the stock market context (as summarized by Calvet et al., 2009b) poorer individuals have been shown to have lower stock market diversification (Calvet et al., 2007; Goetzmann and Kumar, 2008; Vissing-Jorgensen, 2003), have more inertia (Agnew et al., 2003; Campbell, 2006; Calvet et al., 2009a) and are more likely to hold onto losing stocks (Calvet et al., 2009a; Dhar and Zhu, 2006). On the other hand, Agarwal et al. (2009b) find that wealth does not impact mistakes in the choice of a credit card. Each of these decisions can be characterised as being (1) decisions that are made relatively rarely, (2) decisions that usually involve significant mental processing and require at least some financial sophistication and (3) decisions where a mistake can involve significant costs to the individual.

The aim of this paper is to examine the relationship between wealth/income and financial mistakes, where the characteristics of

* Corresponding author. Tel.: +1 736 2100; fax: +1 416 736 5687.

E-mail addresses: Barry.Scholnick@ualberta.ca (B. Scholnick),

nmassoud@schulich.yorku.ca (N. Massoud), asaunder@stern.nyu.edu (A. Saunders).

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the mistake are very different from those described above. Specifically, we examine individuals who fail to make the minimum monthly payment on their credit cards, *even though they have sufficient funds available in their deposit accounts to make the required payment*. We argue that this kind of mistake is different from the mistakes described above in at least three dimensions. First, while the mistakes examined in the literature involve decisions made relatively rarely (choice of stock portfolio, choice of a credit card) the mistake that we examine here (failing to pay the minimum credit card balance) involves actions that have to be made regularly every month. Second, while the portfolio choice or credit card decisions described in the literature require at least some degree of mental processing and financial sophistication, we argue that relatively less financial sophistication and mental processing is required for the individual has to use available funds in his/her deposit account to pay the minimum credit card balance each month. Third, while the costs involved in inadvertently failing to pay the monthly credit card balance are certainly non-trivial (including penalty fees, possible reduction in FICO score and possible increase in card interest rate), these costs would usually be less than the large costs imposed following a mistaken choice of stock portfolio or type of credit card.

In brief, we aim to examine whether the common finding in the literature that the poor make worse financial decisions when the decisions are rare, difficult to understand and costly, (as summarized by Calvet et al., 2009b) also applies to actions that are more frequent, simpler to understand, and where mistakes are less costly, even after controlling for education etc. We argue that where the decisions are frequent, easier to understand and less costly, a variety of alternative arguments can be made which suggest that richer rather than poorer individuals make more mistakes, or even that wealth/income has no impact in predicting such mistakes. The aim of this paper is to provide empirical evidence on this issue. This issue has important policy implications, because if it is found that poorer individuals are more likely to make these kinds of mistakes, in addition to the larger kinds of mistakes already documented in the literature, then this implies that poorer individuals are subject to a larger set of mistakes than previously documented.

A recent article in the Wall Street Journal highlights the possibility of richer individuals inadvertently failing to pay their credit card balance by noting that “*even the rich need to worry about credit scores. But many affluent investors unknowingly hurt themselves with late (credit card) payments*” (Wall Street Journal, 16 February 2009). A number of arguments can be put forward as to why wealthier individuals could make credit card repayment mistakes. First, some elements of the costs of failing to pay the minimum card balance are fixed and invariant to income (e.g. a penalty fee of \$35) thus it could be argued that these costs would be less consequential for rich individuals than for poorer individuals. Thus the poor could be more diligent in ensuring that the monthly credit card bill is actually paid. A second argument as to why the rich could inadvertently fail to pay their credit card bill on time follows from the research of Hamermesh and Lee (2007). They show that higher earning individuals have more time stress (i.e. less free time), which could imply that these individuals have a higher opportunity cost of undertaking actions required to ensure that the credit card payment is made on time each month.

On the other hand, arguments can also be made as to why poorer individuals may be more likely to fail to pay their credit cards, even though they have sufficient funds on deposit to pay. First, failure to pay the monthly credit card balance inadvertently may indeed be related to lower levels of financial literacy, education or financial sophistication in that poorer individuals may not understand the unnecessary costs imposed on them for failing to pay on time.

Secondly, lower income individuals may be unable to implement the financial organization which facilitates the regular and timely payment of their credit card payments. Thirdly, non payment of a credit card balance could result in a reduced FICO score. This may have a greater impact on richer individuals if their total debt outstanding is higher. This may cause richer individuals to take more care in ensuring that their monthly credit payments are made on time to avoid a negative impact on their FICO scores.

In addition, a third group of possible motivations for this kind of mistake may be because of issues unrelated to wealth. These include instances where the individual is distracted from paying the monthly credit card balance by holidays or family emergencies etc. which could apply to both richer and poorer individuals alike.

In summary therefore, this paper emphasizes that it is not a priori clear whether richer or poorer individuals can make such mistakes. Issues of organizational abilities or time stress could apply to either richer or poorer individuals. Alternatively, the costs of these mistakes can apply differently to richer or poorer individuals. The rich could be more impacted by cost from reduced credit ratings, while the fixed costs of the mistakes could have a relatively larger impact on the poor. Our main contribution is to argue that it is not a priori clear as to who is most vulnerable to these kinds of mistakes, and then to document that these mistakes have a larger impact on the poor.

This finding clearly has important policy implications. Our findings imply that not only are the poor more likely to be subject to mistakes involving lack of financial literacy (as described in the existing literature), but further we show that they are also more likely to be subject to mistakes arising from issues such as time stress, inattention and organizational abilities, as we document here. Following the crisis of 2008, a large amount of attention has been paid to which kinds of individuals have been subject to different kinds of financial mistake. The aim of this paper is to document another kind of mistake that has not been addressed in the literature. Our findings are of importance for various agencies dealing with Consumer Finance (e.g. the Consumer Finance Protection Bureau in the US) because it identifies that not only are poorer individuals more likely to make mistakes associated with issues related to financial literacy, they are also more likely to make mistakes related to issues such as inattention, time stress and organizational abilities etc.

In order to investigate the link between wealth/income and credit card repayment mistakes, we build a large database of over one million observations by matching three original databases. The first component of this consists of confidential individual monthly statement data on credit card and bank accounts for more than 75,000 individual bank customers. This provides us with data on which individuals are delinquent while simultaneously having sufficient funds on deposits to avoid delinquency. These data are monthly and cover 19 months from December 2004 to June 2006. The second data base is postal code level census data provided by Statistics Canada which provides a large amount of economic (e.g. income and wealth) and other (e.g. age, education etc.) data, which we link to each individuals postal code. Our third dataset is postal code level data on all residential property transactions, taken from the Land Titles Registry which enables us to derive postal code level house price indices as wealth measures. Importantly, our database exploits a unique feature of the Canadian postal code system whereby the number of households in each Canadian postal code area averages 200 households, which is significantly smaller number than that which can be generated using US Census data. This provides us with relatively fine grained data on economic, demographic and other control variables, which can be matched to our individual level bank credit card and deposit account data.

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