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Unrealistic optimism in consumer credit card adoption

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Abstract

In this paper, we study consumer credit card adoption behavior when individuals are overly optimistic about their future usage of the card. We hypothesized that the more prone consumers are to unrealistic optimism, regarding their future borrowing behavior, the more likely they are to prefer credit cards with features that are sub-optimal in light of their actual borrowing behavior. The two empirical studies we conducted to test these hypotheses have provided supporting evidence. Our findings offer an alternative explanation to the long debated puzzle on the stickiness of credit card interest rate, and have important implications for public policy makers.

JEL classification: G2

PsycINFO classification: 3920

Keywords: Unrealistic optimism; Behavior decision theory; Credit card adoption

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1. Introduction

In many continuously provided services such as financial services, insurance, health care, wireless phone plans, etc., marketers often use versioning strategies to attract more customers by providing similar types of service but with variations in certain features. The buyers' choice of these offerings often depends on customers' expectations on how likely they are going to use or benefit from those provided features. A better understanding on consumers' expected usage level of service attributes plays an important role in helping marketers to understand consumers' service purchase decisions and to design more effective targeting strategies.

Consumer satisfaction with the service and subsequent usage are influenced by the individual's judgment on both the current payment and usage level and the normative expectations (Bolton & Lemon, 1999). In many service purchase situations, some consumers may form a distorted view on their future expected usage level of service attributes or expected benefits derived from usage, that is, many tend to underestimate their future usage behavior. In this paper, we study how such systematic judgment error, the *unrealistic optimism* (also called *wishful thinking*) regarding the future usage, impacts consumer decisions on consumer credit card adoption.

Imagine two consumers with the following behavior. Alice intends to pay off credit card balance in due time, but ends up always keeping a large amount of balance in reality. Bob has the same debt paying intention as Alice, but only keeps a very small amount of balance in his cards. Two levels of questions arise from the example we lay out above. *On the micro level*, would Alice and Bob have different card adoption behavior? How sensitive are they to major credit card features such as APR (annual percentage rate) and annual fee when making card adoption decisions? If their responses to card attributes are different, how can credit card marketers make use of this difference to their benefit? *On the macro level*, what are the implications for public policy makers if consumers like Alice end up making sub-optimal decisions in their credit card adoption? Would this micro level consumer behavior have anything to do with the rigidity of credit interest rates in comparison with those for most consumer loans? In this paper, we address the aforementioned issues by exploring the link between one such systematic judgment error, the *unrealistic optimism,* and the sensitivity of consumers to APR and credit card fees.

For credit card users, APR is irrelevant if the balance is actually repaid every month. However, at time of making a decision whether to adopt a credit card, the decision is driven by a customer's *belief* that this will happen, not the actual outcome. Ceteris paribus, the higher the degree of *unrealistic optimism*, the stronger the *belief* that balances will be paid off each month, the less the sensitivity to APR. We thus hypothesized that the more prone consumers are to unrealistic optimism, regarding their future borrowing behavior, the more likely they are to prefer credit cards with features that are sub-optimal in light of their actual borrowing behavior. In other words, the more prone consumers are to unrealistic optimism, the less sensitive they will be to APR and the more sensitive they will be to annual fee when adopting a credit card. In the previous example, Alice is more unrealistically optimistic about her debt paying ability than Bob is, and hence Alice is more likely to underestimate her future usage on a credit card with lower APR. On the other hand, Alice will be more sensitive to fee since she is less likely to make a trade off between APR and fee by taking on a higher fee for a lower APR.