Consumer Credit Literacy: What Price Perception?

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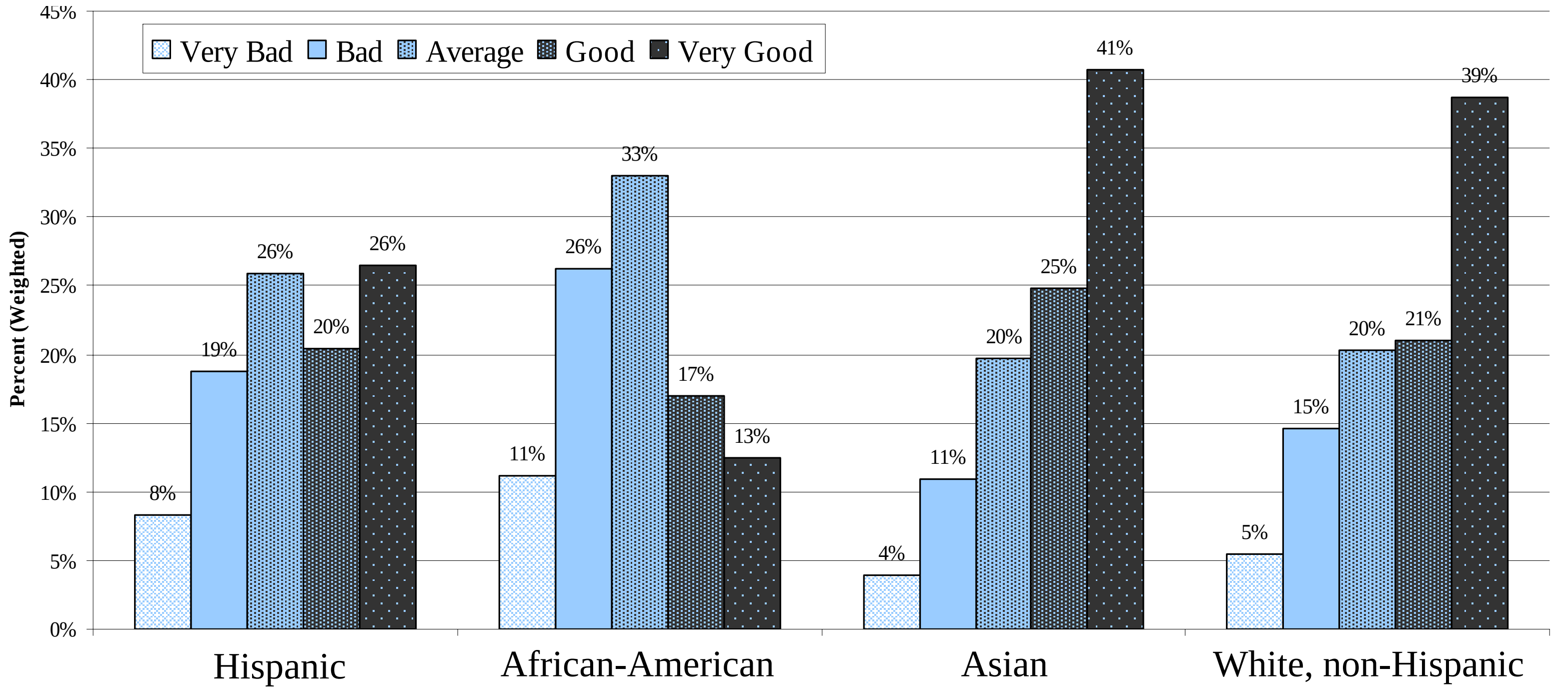
Overview

- There is a burgeoning industry in credit literacy programs and the provision of credit scores, but there is little empirical evidence supporting the need for or effectiveness of these efforts.
- Our research attempts to fill this gap by asking two key questions
- How accurately do consumers self-assess their credit?
  - *Answer:* Not particularly accurately, especially among African-American and Hispanic consumers. But the differences in accuracy across race/ethnicity are explained almost entirely by the differences in credit score distributions.
  - We also find some support for our hypothesis that financial knowledge and factors that encourage investment in understanding credit will increase accuracy.
- Is inaccurate self-assessment associated with bad financial outcomes?
  - *Answer:* Somewhat. We do find that consumers who underassess their credit (i.e., assess their credit lower than it actually is) are more likely to end up with bad outcomes, but consumers who overassess their credit (i.e., assess their credit higher than it actually is) are more likely to end up with good outcomes.

Research Strategy

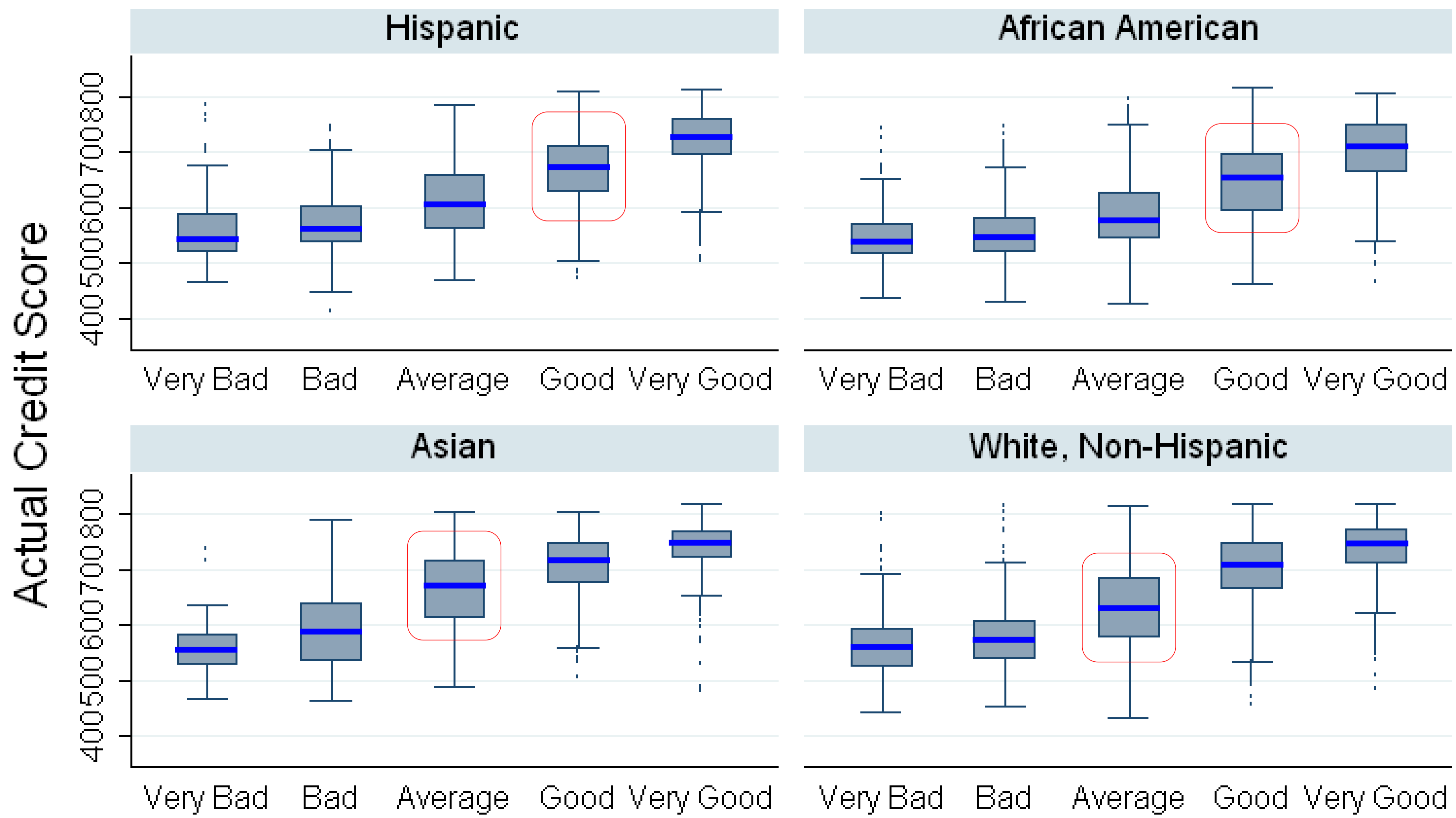
- Why might consumers error in their assessments, and why might it matter?
  - Credit reporting and credit records are arcane, and their relationship to loan performance/profitability is complex.
  - Consumers who self-assess credit to be lower than it is may inappropriately apply for less than prime credit or unknowingly pay a higher price for the credit they receive.
  - Consumers who self-assess credit to be higher than it is may over-extend themselves in requesting 'too much' credit or not shop sufficiently and therefore inappropriately end up with a higher-priced or non-prime mortgage.
- Data used to assess accuracy of credit self-assessment come from a survey of 12,140 respondents conducted in 2000.
  - Survey asked the question, "How would you rate your ***current*** credit record?"
  - We also obtained current FICO score and a variety of other variables for each respondent.
  - The latter data allow us to identify factors that are associated with inaccurate assessment.
- Use survey data plus loan-level data on mortgages originated by prime and subprime lenders in 2004 and 2005 to assess market outcomes.
  - We use relationships in the survey data to impute credit-assessment in the lender data.
  - We expect to find that inaccurate self-assessment leads to undesirable financial outcomes.

Self-Assessment of Credit



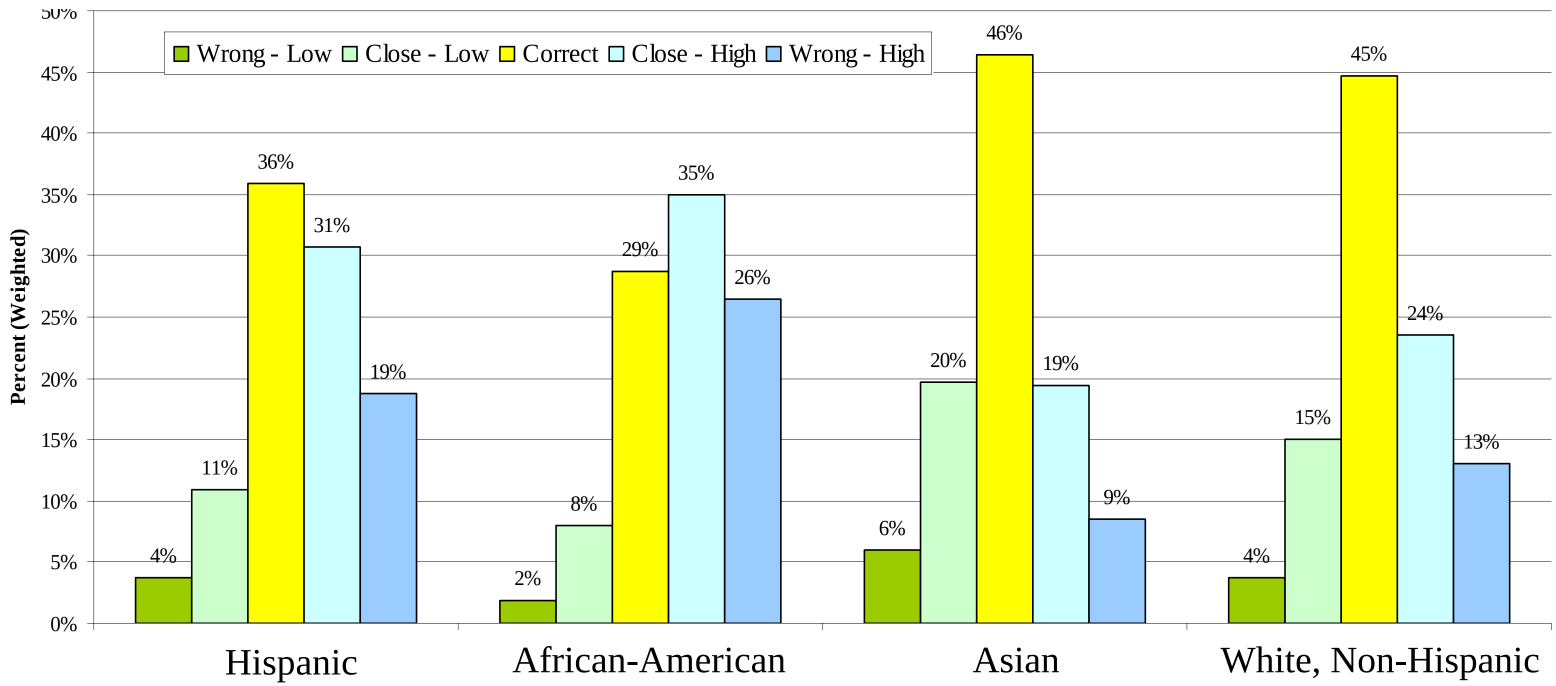
- African-American and Hispanic respondents have a more "pessimistic" self-assessment of their credit than Asian and White, non-Hispanic respondents.

Self-Assessments Align Pretty Well With FICO Scores



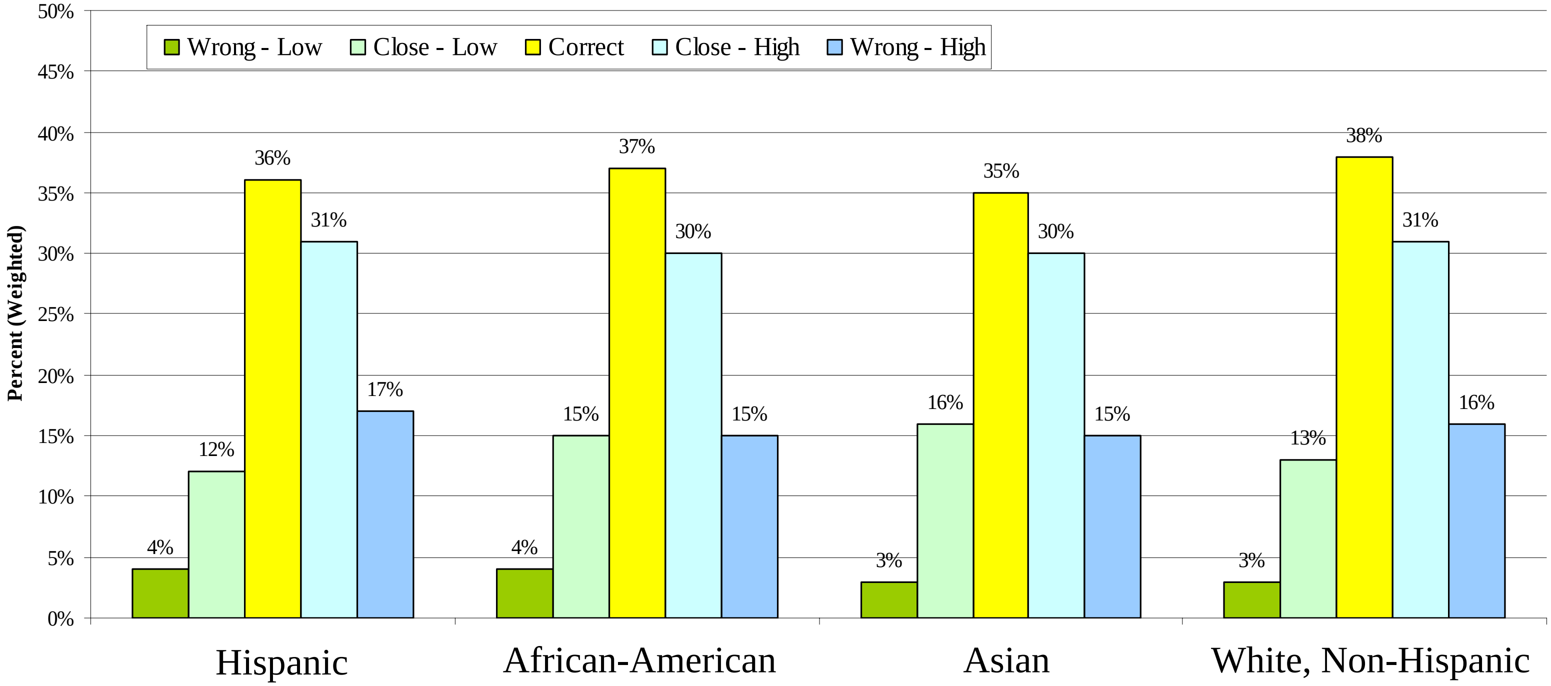
- Self-assessment increases with FICO score, but there is a lot of overlap.
- Similar FICO score distributions are associated with different self-assessments across race/ethnicity.

Self-Assessment Accuracy Differs by Race/Ethnicity



- Respondents generally overassess their credit (i.e., believe it is better than is reflected in their FICO scores).
- Asian and White, non-Hispanic respondents are more consistently "correct" in their self-assessment of credit.

Race/Ethnicity Differences are Due to FICO Scores

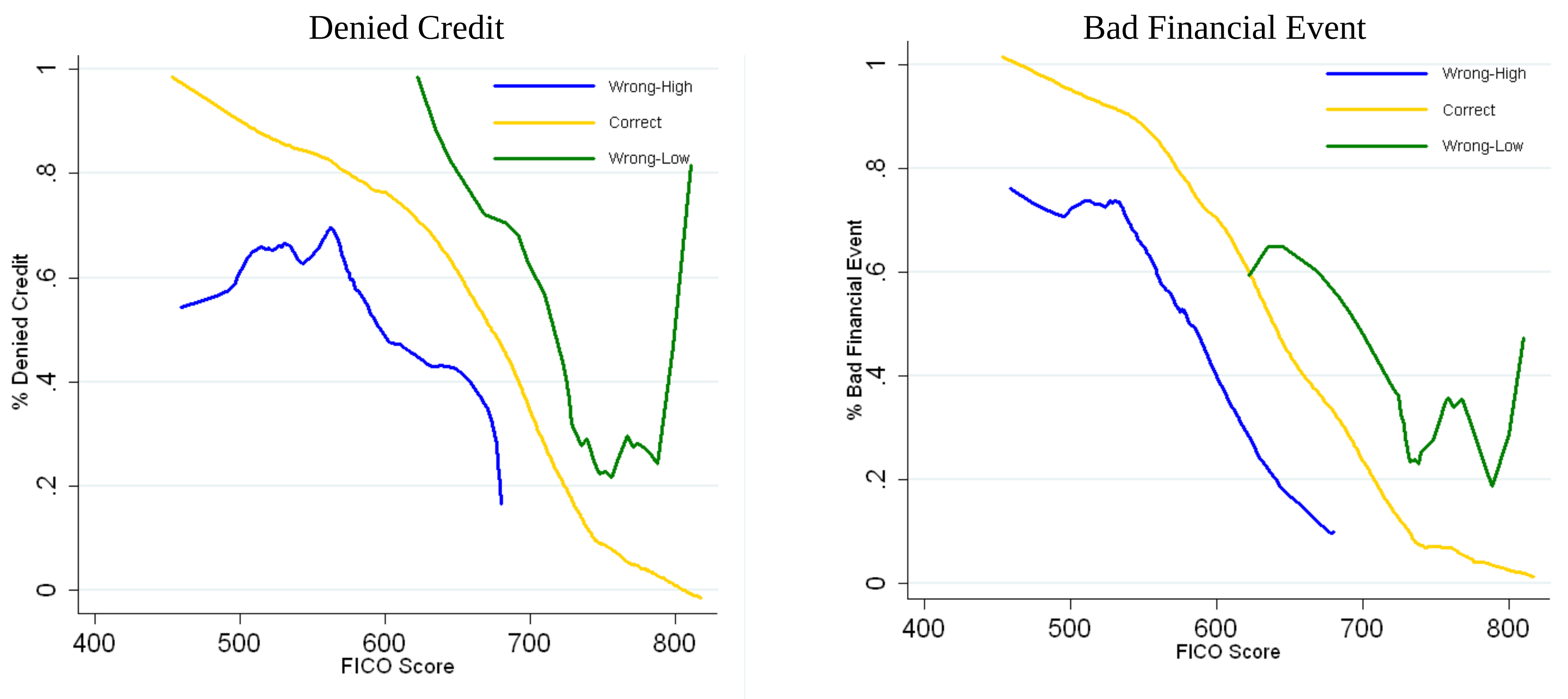


- Respondents with low FICO scores are far less accurate in their self-assessments.
- After adjusting for differences in FICO score distributions, self-assessment accuracy varies little by race/ethnicity.

Other Factors are Related to Accurate Self-Assessment

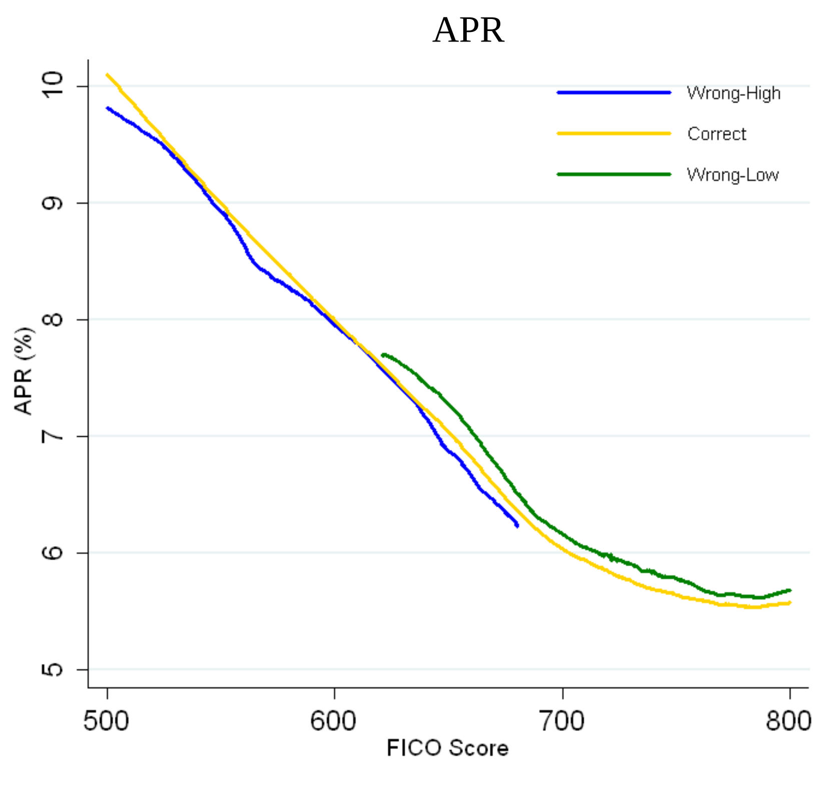
- We expect accurate self-assessment to be driven by financial knowledge and the incentive to "invest" in learning about credit.
- We use a variety of variables motivated by these expectations to predict self-assessment accuracy.
- We find some support for our hypotheses.
  - The greater the percent of households in the neighborhood (tract) with mortgages, the greater the likelihood of accurately rather than overassessing credit.
  - The less likely respondents are to take risks, the more optimistic they are about their future, the more they have had money worries, and the more they have an internal locus of control, the greater the likelihood of accurately rather than underassessing credit.
- However, the results are not entirely consistent with our hypotheses, and arguably suggest that our identified factors are more consistent with "optimistically" rather than "accurately" self-assessing credit.

Bad Outcomes are Related to Inaccurate Self-Assessment



- Bad financial outcomes are more likely with lower FICO scores.
- Respondents who inaccurately self-assess too low are more likely to have bad outcomes. However, borrowers who inaccurately self-assess too high have better financial outcomes.

APR is Related to Inaccurate Self-Assessment



- Higher APRs are associated with lower FICO scores.
- Respondents who inaccurately self-assess to low are more likely to have higher APRs. However, borrowers who inaccurately self-assess too high have lower APRs.

Summary and Implications

- There are potential concerns about the accuracy with which consumers self-assess credit.
  - Consumers with lower FICO scores are less likely to assess accuracy.
  - There are important differences in the accuracy of self-assessment across race/ethnicity, but these are driven largely by differences in FICO score distributions.
  - Consumers with greater financial knowledge and the incentive to invest in learning about credit are more likely to "optimistically" than "accurately" self-assess.
- Inaccurate self-assessment has market implications.
  - Consumers who underassess their credit are more likely to be denied credit, experience bad financial events, and have higher APRs on their mortgages.
  - However consumers who overassess their credit are less likely to suffer bad outcomes.
- A possible reconciliation of these results is that optimistic consumers may know factors about their credit that both they and lenders recognize as reducing risk, but which are not (fully) captured in FICO scores (for example, excess reserves, financial safety net).