Costly Mistakes in Credit Markets: Evidence from Consumer Loans

Jacelly Cespedes*

March 2017

Abstract

This paper studies how well borrowers choose their credit contracts and to what extent borrowers’ sophistication can be informative about their unobserved creditworthiness. To this end, I exploit a new source of quasi-experimental variation in interest rates, along with bunching methods. In the setting, the loan interest rate schedule features discrete jumps at specific loan amount thresholds, which create strong incentives for bunching below the thresholds. Contrary to what the benchmark model predicts, the findings show that not all borrowers minimize their financing costs. The estimates indicate that one percentage point increase in the interest rate reduces the demand for unsecured credit by 2.4%, but there is substantial heterogeneity in the sensitivities across borrowers. I explore different hypothesis for the lack of bunching, and I find that sophistication accounts for most of the heterogeneity, while liquidity constraints, adjustment costs, and saliency play only marginal roles. Finally, I find that borrowers who select not to bunch are more likely to default on their loans, and that lenders exploit this information when granting loans.

*First version: September 2016. The University of Texas at Austin McCombs School of Business, 2110 Speedway, Stop B6600, Austin, TX 78712 (jacelly.cespedes@utexas.edu). I would like to thank Andres Almazan, Aydogan Alti, Jonathan Cohn, Cesare Fracassi, Inessa Liskovich, Zack Liu, Daniel Paravisini, Carlos Parra, Robert Parrino, Clemens Sialm, Laura Starks, Sheridan Titman, Gregory Weitzner, Qifei Zhu and seminar participants at the University of Texas at Austin. The findings and conclusions in this paper are solely the responsibility of the author and do not reflect the views of Lending Club. All errors are my own.