An Examination of the Adverse Effects of Consumer Loans

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Abstract

The dramatic increase in the consumer debt burden and consumer bankruptcies are indications that restrictions should be imposed on the availability of consumer unsecured loans. Financial services firms treat consumer unsecured loans as if they are evaluating business loans. They treat the pool of loan applicants as if they are a pool of insurance applicants Consumers on the other hand see the easy credit as an opportunity to abandon fiscal responsibility and depend on borrowing to meet their consumption needs. The explosion of the real estate market helped support this obsession with debt-financed consumption. This paper discusses the negative effect of consumer debt for consumption and argues that credit card return to its original intent as a convenient means of payment; that all non-investment consumer loans be severely restricted due to its disparaging harmful effect to the segment of the society that can least afford it.

Keywords: Consumer loans, Default-risk premium, Savings rate, Economic growth, Investments, Loan delinquency

1. Introduction

Consumer loans account for a major component of loan portfolios of financial services firms. The ability of consumers to obtain loans is a firms. The extra premium on loan rates paid by consumers act as dead weight on the consumption major driver of consumption in the durable sector of the economy. The burden of delinquency is reflected in the price of goods and services and the profitability of business. Loan write-offs are a major cost of doing business for financial decisions services of households. It also serves as an avenue for the transfer of wealth from those who can least afford it to corporate shareholders as well as from the consumers who make their payments to those who default.

The global economy is struggling to recover from the greatest economic disaster since the great depression. The belief is that the melt down in the real estate sector was a result of sub-prime loans and unscrupulous underwriting practices fueled by the expansion of mortgage backed securities market. To date, there has been no reference to the role of other consumer debt on the deterioration of the consumers' ability to honor their mortgage commitments. The objective of this paper is to demonstrate the role of consumer credit characteristics and the miss-application of business-loan valuation practices on consumer loans, on the incidence of loan defaults. This paper argues that defaults in non-asset backed consumer loans were the primary driver of mortgage loan defaults. Moreover, the high default risk premiums on consumer debts create a moral hazard condition for consumers that do not exist for corporations. The risk of a business loan depends on the cash flows expected from the projects funded by the loan. This risk is a function of the market's reception of the goods/services produced by the project. On the contrary, the riskiness of a consumer loan depends on activities of the consumer. The funds have been spent and the benefits have accrued to the consumer, repayment of the loan involves a trade-off between current consumption and future consumption that may not be possible because of denial of future credit. This is the key difference between consumer and corporate loans. With business loans, future expected benefits and the repayment of the loan are tied to the project funded by the loan. This is not the case for consumer loans. Thus, the essence of this paper is to detail the adverse effects of consumer loan default-risk premiums on consumption, wealth transfer and economic growth and to suggest a strong restriction on non-investment related consumer loan. The paper consists of the following subheadings: Differences between consumer and corporate loans; Consumer characteristics and incidence of consumer debt; The Case against consumer consumption loans; Default risk premium and consumer loan delinquency; Consumer loans and personal financial management; Recommendation and Conclusion.

2. Differences between Consumer and Corporate Loans

It may seem that a comparison or examination of the differences between consumer and corporate loans is trivial; after all, consumer loans are loans to consumers while corporate loans are loans to corporations. This distinction focuses exclusively on the economic unit with the obligation to fulfill the terms of the promissory note. As a result, financial analysis evaluates these loans using the same tools and assigning default probabilities and premiums. This approach misses the most important distinction between consumer and corporate loans.

Consumer loans are classified as either for investment in durables (home and automobile loans) or consumptions (nondurables and services). On the contrary, corporate loans are used to finance investment projects. The whole concept of capital budgeting is to assess the profitability of an investment to determine if it will increase shareholder wealth. A project that increases firm value automatically covers the opportunity cost of the funds employed by the project. Consequently, in the case of debt financing, acceptance of a project also implies that the expected pay-off is enough to service and retire the debt component of the financing. Minelli and Modica (2009) in their study of credit markets and policy, note, “Would-be borrowers have superior information on the quality of their project, or on the nature of their commitment to its success”. As a result, lenders have to design debt contracts that reflect their lack of this crucial information. Government credit policies are cognizant of the fact that business loans are tied to the riskiness of the project. Minelli and Modica find that the two most widely used credit policies, interest rate and investment subsidies, are designed to enhance the ability of the corporation to service and retire the debt. Interest-rate policies address the adverse selection problem that keeps low-risk-low-return firms from the credit market because of high interest rates. Investment subsidy policies reduce the amount of funds at risk as the government offers a transfer to the firms to reduce the amount of debt financing.

Microfinance is one of the loans that maybe termed consumer loan. However, it is a business loan whose objective is “helping alleviate poverty by expressing faith in the work ethic and entrepreneurial capabilities of the world’s poorest people” (Whittaker, 2008). Whittaker quotes former United Nations Secretary General Kofi Annan’s description of the role of access to credit in helping alleviate poverty by generating income and creating jobs. Thus, the goal of microfinance is to encourage investments in the impoverished areas of the world by providing debt capital. Weller (2009) lists the benefit of consumer loans. Consumer loans allow families to buy a home, car, college education and to smooth out income fluctuations due to “short-term spells of unemployment, medical emergencies etc.” These functions of consumer credit fall under two classes: investments and precautionary needs. The investment component provides for enhanced earning potential that is expected to service and pay the debt. The precautionary elements reflect poor personal financial management practices. Corporations do borrow money for precautionary reasons, but this is usually from lines of credit to finance working capital needs, again a form of investment.

Bankruptcy laws also recognize the difference between consumer debt and business debt. Current bankruptcy law forces consumers to repay their debt from future income. On the other hand, with corporate bankruptcy, the limited liability status restricts the claims of creditors to the current assets of the firm. This is an implicit recognition that corporate debt is backed by the firm’s investment in assets and that these assets serve as collateral to the firm’s debt. White (2007) argues that bankruptcy laws provide debtor with a form of consumption insurance. This is because discharging debt in bankruptcy increases debtors’ consumption when their consumption could have been low due to reduced income. In return, she argues that debtors pay a premium in the form of higher interest rates as financial services firm, cognizant of the potential for the debt to be discharged want compensation for this risk. Moreover, this implicit insurance raises the risk of default. White also argues that in states with high homestead exemption and in situations where personal debt is discharged along with business debt, the consumption insurance through bankruptcy encourages individuals to become self-employed.

Yerex (2010)’s study highlights the major differences between consumer loans and corporate/business loans. Evolutionary forces drive consumer loans, whereas capital budgeting and capital structure decisions determine the level of corporate loans. It is a matter of consumption versus investments. For consumers, it is spending future income now to maximum consumption as opposed to corporate loans, which are based on spending today with the expectation of receiving more in the future.

Another major difference between consumer loans and corporate loans is reflected in the response of both economic units to uncertainty shocks. Knotek and Khan (2011) show that variations in the amount of uncertainty do not appear to be a key factor driving household spending decisions. This is in contrast to business decisions where the real options model correctly predicts that increase in uncertainty causes businesses to postpone investments until more information becomes available. This is especially so in situations where the actions are irreversible. For households, uncertainty does not seem to matter when consumption is the object. Since most household consumption, especially durable goods, are financed with debt, uncertainty of future prospects does not seem to affect household decisions to borrow.

The difference between corporate and consumer loans goes beyond consumption and investment. Corporate loans are driven by capital budgeting and capital structure. The profitability of the investment project, combined with a firm's preferred capital structure, determines business demand for loans. However, for consumer consumption loans, the determinants of demand are completely devoid of the object of consumption.

3. Consumer Characteristics and Incidence Consumer Debt

In consumption driven society like the United States, where personal consumption account for 70 % of the Gross Domestic Product, the interaction of credit and consumption takes on a central role in the debate on consumer credit issues. Yerex (2010) argue that humans have evolved to maximize consumption rather than utility as traditionally defined in economics. He notes that in a consumption driven society, refinements in exchange in the form of financial instruments that "allow for realization in the present of future earnings, and leveraging the value of fixed assets" have lead to increased consumption. This increased consumption is "driven not by higher incomes but rather by the creation of new financial instruments that have allowed consumers to spend more in the near-term". Yerex notes that in consumer societies, virtues such as thrift and self-denial are looked upon negatively as they are considered to lead to economic stagnation. He argues that the dramatic increase in consumer debt is largely due to the relaxation of the liquidity constraint faced by households because of the introduction of new financial instruments that have greatly increased their access to the credit market. He further notes that a significant portion of consumer purchases is done with credit and most of those purchases are for nondurable goods.

Towny-Jones, Griffiths and Bryant (2008), henceforth TGB, documented some of the characteristics of high-risk borrowers in an effort to justify the need for specific intervention. They define two categories of consumers who fall prey to financial difficulties as (1) those who experience financial difficulties irrespective of the general economic conditions, and (2) those who are only prone to financial difficulties when general economic conditions deteriorate. TGB show that consumers aged between 25 and 44 years are the most prone to financial difficulties as evidenced by the disproportionate rate of bankruptcy by this age group. They argue that this period of life is where considerable demands are placed on finances in order to acquire assets and/or meet other living commitments; moreover, this group is particularly vulnerable to loss of income due to unemployment. Green, Harper and Smirl (2009), writing on the impact of financial deregulation on household debt, note that high debt levels commit a greater share of future income to debt servicing and repayment. They refer to debt repayment as savings, meaning to say that instead of saving before consumption, the role is reversed, consume and then save later to pay for it. This situation "potentially increases the volatility of household consumption in the face of unexpected volatility in income".

Telyukova and Wright (2008), in their study of the credit card debt puzzle, postulate that it is because consumers have certain expenses that cannot be paid for with credit cards that is responsible for the observed practice of consumers carrying high interest credit card balances while simultaneously carrying balances in low interest bank accounts. They call this pattern a liquidity problem. They report that "27% of U.S. households in 2001 had credit card debt and liquid assets in excess of $500 and the a median household in this group revolved around $3800 on their credit cards even though they had $3000 in the bank." This approach seems to be looking at the symptom rather the underlying problem. This practice can also be explained as leverage. These consumers use the liquid balances for consumption that cannot be made with credit cards and the rest are paid with credit card debt. The percentage of consumers in this group based on the 2001 Survey of Consumer Finance reported that 29% of those who own three cars and 27% of those who own one car are in this group. It also shows that 30% of homeowners and 22% of non-homeowners were in this credit card debt puzzle category.

Lawrence and Elliehausen (2008) reports on the concept of rationed versus unrationed borrowers. Rationed borrowers are "in the early family life-cycle stage where 'rates of return' on household investments would be high". They have relatively low to moderate income, making "sacrifices in current consumption to satisfy equity requirements very costly". In other words, rationed borrowers live beyond their means. High return on household investments and limited availability of credit makes their demand for credit unresponsive to increases in interest rates unrationed borrowers are the exact opposite. They are in later stages of the life cycle, have high incomes, and hence high discretionary incomes to pay for new household durables. There demand for credit is highly sensitive to interest rates.

Attanasio, Goldberg and Kyriaziduo, (2008) investigated the significance of borrowing constraints in the market for consumer loans. They find that consumers are "very responsive to maturity and less responsive to interest rates". They show that increasing maturity by 1% increases loan demand by 74% for low-income borrowers. For middle-income group, the increase in loan demand is found to be 55%. Their study also show that "decreasing the interest rate by 1% would increase the loan demand of high-income consumer by 14%, versus a 3.1% increase for low-income borrowers, and an 8% increase for middle–income borrowers. The response of consumer borrowers to maturity is another distinct difference with corporate loans. Time value of money concept dictates that the farther into the future the cash flow, the less it is worth today. Businesses unlike consumers will like to defer payments as far into the future as possible. Secondly, corporate loan are more sensitive to interest rate increases as this will increase the cost of capital and hence reduce the projects net present value and the probability of acceptance. According to the findings of Attanasio, Goldberg and Kyriaziduo, low to middle-income borrowers are not particularly sensitive to interest rate changes. This is because the motive and goal is maximization of consumption as opposed to the value of the firm maximization for corporations.

4. The Case against Consumer Consumption Loans

The case for consumer loans has its roots in the Permanent Income Hypothesis (PIH) and the Life Cycle (LC) theories of consumption. PIH contends that individuals tend to smooth out consumption based on expected income over their lives. The goal is to maximize the marginal utility. This is where the problem lies with the PIH model. It says nothing about the uncertainty in future income. Utility maximization is subject to some associated cost with the benefit. In spending future income today, in exchange for an unknown and uncertain income tomorrow creates a moral hazard and adverse selection complex. According to Schooley and Worden (2010), henceforth SW, both the PIH and LC models of consumer consumption assume rational tradeoffs between current and future consumption. Neither model addresses attitude towards credit. A household's decision to borrow to finance current consumption with expected future income implies that current consumption is preferred to future consumption (Schooley and Worden, 2010). This inter-temporal consumption decision ignores the fact that repayment of the borrowed funds starts with the next billing cycle (20 days). This creates a snowball effect. A household that is unable to meet their consumption expenses must not only try to meet those expenses, but now has the added burden of paying both the interest and principle on borrowed future income needed to fund current consumption. This creates a need to borrow more money and the cycle continues, except in situations where the borrowed funds is used for investment and the payments from reduction in current expenses serves as the investment's cash flow.

Schooley and Worden argue that easy credit and a seemingly unlimited attitude for consumption may influence households to consume now regardless of the consequences later. Even though most theoretical models assume that households tend to smooth consumption over time. Schooley and Worden contend that they may not be looking beyond today. In other to understand consumers attitude towards credit and debt, SW tried to investigate peoples attitude towards borrowing to take a vacation, and borrowing to pay for day-to-day expenses when there is a decline in income. They find the 15% are willing to borrow to finance luxury items and 50% are willing to borrow to cover living expenses. Borrowing to cover day-to-day living expenses is equivalent to digging themselves into a deeper and deeper hole with each passing period. This is the problem with easy consumer credit. It has apparently nothing to do with future income, but everything to do with satisfying current consumption even if it is the purchase of luxury item. Their study also shows that young singles are more apt to borrow to acquire luxury items as well as to cover living expenses.

SW show that households with less debt capacity and who are less likely to qualify for consumer loans/credit, are the households that most condone borrowing to buy luxury items to cover living expenses when income is short. Worst of all, they find that households who do not practice sound financial practices deem borrowing for any reason to be appropriate. When these findings are taken together with the liberal credit policies pursued/practiced by financial institutions, it creates a perfect condition for credit crisis. SW show that "a higher percentage of households demonstrating no Financial Discipline- those who have no savings plan, revolve their credit balances, or have been late or missed loan payments- condone borrowing when income is cut. The question is how you service your debt when you are experiencing decline in income and the servicing of the debt worsens the financial position. Financial services institutions contend or belief that higher interest rates will serve as a deterrent and ration credit to families who are qualified. However, higher credit when the borrower cannot meet day-to-day living expenses creates a situation where the borrower pays the minimum and leverages the rest of their income. This situation, which is clearly unsustainable, leads to the cry "all this bills keep coming".

Based on a multivariate analysis of consumer borrowing attitude, SW find that a households' credit attitude has a significant impact on is probability of participating in credit markets. Households, who believe that it is all right to borrow for vacations and other luxury items or to cover living expenses when income is cut, are 45 percent more likely to participate in the consumer debt market than those who do not condone borrowing for these purposes. They also find that households with no consistent saving rule are significantly more likely (30 percentage points) to have consumer debt than those households who do have a saving rule.

Another issue with consumer loan is the role of materialism. According to Prinsloo, "increased levels of domestic spending can provide a very positive stimulus for economic growth"; but when it occurs at the cost of household savings in the form of increased consumption and credit usage, it becomes damaging to the economy (Jacobs and Smit, 2010). Borrowing for consumption today substitutes future consumption for current consumption. This leads to reduced future economic growth. Materialism has several definitions. Belk defines it as "the importance a consumer attaches to worldly possessions" (Jacobs and Smit, 2010). According to Jacobs and Smit (2010), henceforth JS, studies by Fitzmaurice & Comegys, and Watson, show that materialism is an important variable in predicting consumers' propensity to incur debt. Thus, in a materialistic society, availability of consumer credit feeds on the innate need or propensity of the consumer to borrow and spend. Watson argues, "With the availability of credit comes the ability to acquire things in the present and pay for them in the future". 'This ability is particularly appealing to the highly materialistic individual, for whom the immediate desire to consume can be overwhelming' (Jacobs and Smit, 2010). JS studied the relationship between materialism and indebtedness within South African low-income consumer population. They conclude that low-income consumers in South Africa are very materialistic. The implication of this finding can be profound. The study group is the low-income consumers with the ability to use debt as a means of acquiring strictly consumer goods from the country's leading consumer products retailer: HomeChoice. They report that household indebtedness increased by 44% between 1994 and 2008 while household consumption increased by 375%. Similarly, debt owed to retailers increased by 350%. Consequently, the increase in consumption was fueled by borrowing, a condition that does not bode well for future economic growth.

White (2007) writing on bankruptcy reform and credit cards, argues that the increase in personal bankruptcies are a result of rapid growth in revolving debt (credit card debt). From 1980 to 2004, household revolving debt increased from 3.2 to 12.5 percent of U.S. median family income (White, 2007). In 2004, White reports that the average bankruptcy filer had a credit card debt of $25,000. In the same period, the number of bankruptcy filings increased by more than five times (520.83%) from 288,000 to 1.5 million. It can be argued that several other factors such as job loss, medical costs, and marital problems, which lead to income reduction, contribute to financial distresses that ultimately result in bankruptcy. A study conducted in 1996 by the Panel Study of Income Dynamics (PSID) show that adverse events are not central in bankruptcy filings. The study showed that only 21 percent and 16 percent of bankruptcy filers gave job loss or illness, injury, or medical costs, as their primary reasons for filing, respectively (White, 2007). White also reported on the study of Sullivan, Warren, and Westbrook that suggested that increase in bankruptcy filings was because "bankruptcy has become a middle-class phenomenon", leading to higher income earners filing for bankruptcy. This conclusion goes against the fact that in 1981, 1991, and 2003, the median income of filers was 70 percent, 50 percent and 49 percent, respectively, of the U.S. median family income. Thus, concludes White, that the "typical bankrupt has become poorer over time, not more middle class". In the PSID study, 33 percent gave high debt/misuse of credit as their primary reason for filing. In the National Foundation for Credit Counseling survey of debtors who sought counseling before filing, two-thirds gave "poor money management/excessive spending" as their reason for having financial difficulty (White, 2007).

Bankruptcy is not a decision taking lightly. It is an admission of failure in the effort to manage their financial affairs. It effectively destroys the filer's credit standing, making it extremely difficult to invest in homeownership or purchase a vehicle on credit. It even limits the filer's employment prospects. To realize that the primary cause of this hardship is the availability of consumer credit raises serious questions about the role of consumer credit in an economic system.

The availability of consumer loans in and of itself is not a problem; rather, it is the potential for abuse by the demographic group without the ability to withstand the temptation to consume from future income to feed their desire/appetite for instant gratification. Innovations in financial services caused by changes in usury laws changed the operating environment for consumer loan providers. Reduced cost of credit, through the development credit bureaus and credit scoring models and the elimination of the face-to-face application process, allowed lenders to expand nationally. The introduction of revolving credit allowed lenders to change interest rate any time. It also allowed borrowers to choose a repayment period. This is in contrast with secured installment loans that usually have a fixed repayment period and interest rate (White, 2007).

Consumers can be classified as either rational (exponential) discounters or hyperbolic discounters. This classification is based on the consumer's attitude towards current versus future consumption. As reported by Eisenhauer and Ventura (2006), hyperbolic discounting entails an inverse relationship between time and the discount rate. In practice, the term is more generally applied to "any manifestation of increasing impatience" as time horizon decreases (Eisenhauer & Ventura, 2006). White (2007) discusses the findings of Liabson et al on the borrowing characteristics of hyperbolic discounters. Their study shows that hyperbolic discounters "borrow more than three times as much as rational consumers regardless of whether both types pay the same interest rates or hyperbolic discounters pays higher rates". White concludes that hyperbolic discounters are:

- More likely use credit cards for borrowing rather than transacting like rational discounters
- Want to save more starting at some point in the future
- Will accumulate high levels of credit card debt because each month they resolve to start paying it off but when the next bill arrives, they consume too much and postpone repaying for another month.
- Prefer current consumption to future consumption
- Less likely to utilize commitment devices to constrain their future choices

Eisenhauer and Ventura (2006), studied the characteristics of hyperbolic and exponential/rational discounters using data from a survey of 3200 Italian respondents. They find that based on both univariate and bivariate analysis, hyperbolic discounters are "younger, poorer, less educated, blue-collar and unemployed individuals who reside in larger cities" than rational discounters. This finding has far-reaching implications for consumer loan practices. It indicates that consumer-lending practices tend to prey on the weaknesses of hyperbolic discounters.

That the United States economy is consumer driven is something that the press brags about with respect to the resilience of consumer spending and its effect on economic growth. This resiliency comes with a price: high debt and low savings rate. Feldstein (2006) discusses the impact of low savings rate on economic activity as he advocates a return to savings. Some of the negative impact of low savings rate includes dependence on capital from overseas to finance investment; reduction in productivity enhancing net business investment that serves as an engine for future economic growth; an increase in spending by Americans, which has induced an increase in U.S. imports, contributing to output growth of many countries around the world. A lot of the growth rates in GDP (Figure 1) shows the relationship between the U.S. savings rate and growth in GDP from 2001 to 2010. The data, obtained from the Bureau of Economic Analysis (BEA), is presented in Table 1. The graph shows a strong negative relationship between savings rate and economic growth (BEA, 2011). In the short-term, increase in saving results in a reduction in GDP. However, in the long run, the increase in capital and investment reverses that trend and both GDP and savings rate both become positively correlated.

5. Default Risk Premium and Consumer Loan Delinquency

The interest rate financial services firms charge on loans consists of two components: the risk-free rate and the risk premium. The risk-free rate compensates the lender for the pure time value of money and the loss in purchasing power and is largely proxied by the yield on the U.S. Treasury bill. The risk premium represents the loss exposure stemming from the duration of the loan, illiquidity of the security and the probability that the borrower will default on the loan. The default risk premium is by far the largest component of the interest rate on consumer loans. It is largely determined by the borrower's FICO score. Developed by Fair Isaac Corporation, FICO credit score is a rank-ordering of consumers' creditworthiness meaning that individuals with higher scores are anticipated to manage their debt than those with lower scores (Demyanyk, 2010).

Determination of a consumer's FICO score is a three-step process. In step one, information about the consumer is analyzed using "proprietary statistical model" that predicts the likelihood that the consumer will be more than 90 days past due on a credit obligation within the next two years. The output of the model is the consumer's odd ratio, the sum of the consumer's good credit behavior divided by the sum of his or her bad credit behaviors. In step two, consumers are assigned to groups, termed scorecards, based on similar events in their credit history. Consumers are assigned score card scores based on how harmful their behavior is considered to be to their creditworthiness, with consumers with the most harmful behavior assigned the lowest range of credit scores while those with the best behavior enter a scorecard with the highest ranges of scores. The third step is where the odds ratio is mapped to a credit score for each consumer based on their scorecard position. This is the information lenders use when evaluating a potential borrower's likelihood of default, and whether to grant the loan request and at what interest rate (Demyanyk, 2010). Demyanyk notes that because the credit score is a rank ordering, it cannot be compared across time since the effect of a change in consumer behavior and hence the odds ratio, depends on the credit behavior of everyone else in the population.

Odd ratios are results of statistical and mathematical models based on past behavior of consumers. Estimating default probabilities based on historical data and projecting and applying those probabilities to the future, assumes the future will be like the past. This type of assumption puts the modelers on treacherous grounds if the future differs from the past (Watson, 2008). This is a major disadvantage of the credit scoring system. Individual behavior and decisions are determined by current personal financial situation, which may have nothing to do with the past economic circumstances. Human beings for the most part want to do better. As a result, past negative or creditworthiness-harming actions, which are dependent on the situation under which they were taken, cannot be expected to continue in the future and to evoke the same response from the consumer. Unfortunately, credit-scoring models, which do not take into account the circumstances except to look at the general population, expects past behavior to continue into the future.

Financial services firms rely on the FICO score to varying degrees. American Express Co. for example uses "more as a point of reference"; Discover Financial Services uses FICO, but take the information and "enhance it with a ton of other data and variables". Amex uses a FICO to rank prospects, but bases its approval process on other data (Fitzgerald, 2008). Regardless of the data used, they all have one thing in common: they are all past, historical data. They all look backwards, while moving forward. Moreover, all the statistical models rely on large sample models. The models predict the average behavior of members with a particular or identical past data set. In using this approach, financial services firms base their default risk premium on the average behavior of the group. Predicting the expected behavior of a large sample is easier than that of the individual. The variance of the estimate increases. Using this system of setting the default premium creates the adverse selection problem. Fifty percent of the members of each group lie above the mean (expected value), (assuming a normal distribution, which is appropriate because of the large sample size). Meaning that this same percentage have to pay more than their behavior dictates whereas the other half pay less than their past behavior warrants.

The insurance industry relies on group characteristics to predict their loss experience and hence set the insurance premiums. This concept relies on the law of large numbers and the requirement that the loss is fortuitous. This implies that the insured has neither influence nor control over the insured event (Prichett, Schmit, Doerpinghaus, & Athearn, 199, p. 61). This allows the insurance industry to spread "the misfortunes of a few over many" (all the insured). The situation is different in consumer loans. The consumer has complete control of the outcome. They can choose to keep making payments or default. In this case the many are paying for the benefit of a few. The high default risk premium charged on consumer loans is dwarfed by the benefits given the demographic characteristics of the consumers that are apt to default. The reasoning could go like this: I have been paying this high interest rates because the bank believes that I am going to default. They have already made their money, why should I continue to pay this high rate. Sinkey, Jr., (2002, p 311) gives a model of the default-risk premium as the difference between a risky loan rate (r^*) and a comparable risk-free rate (r), such that for a one-period loan,

$$r^* = \{(1 + r)/(1 - d)\} - 1$$

where d is the probability of default. For a fifty percent probability of default and a risk-free rate of five percent, the default risk premium is 11.67%, resulting in an interest rate of 16.67%. This rate is comparable to the rate on most credit card loans. To the consumer, the cost of defaulting is bad credit and loss of the ability to borrow more money. The poor credit score and high default risk premium already means that the consumer is a very poor risk. Hence, the consequences of delinquency are trivial, but the benefits are enormous. To the delinquent consumption borrower, bankruptcy is good news. It results in increase in purchasing power and hence consumption. This situation is possible because of the very low income to debt ratio. Thus, they qualify for a complete discharge of their debt obligations. The inability to borrow is a blessing in disguise for it forces the debtor to learn to live within their means. It can be argued that bankruptcy is costly to this consumer because of the inability to get good jobs, buy a home or a car. This is in sharp contrast to the demographic characteristics of the people that borrow money for consumption rather than investment. They are already at the bottom: there is no more downside. They are already being crushed by the debt burden, delinquency becomes a relief, hence its attractiveness. Fishbach, Shah and Kruglanski (2004), note that the motivation to perform an act influences people's experience during and after pursuing the action. Intrinsic actions have positive effect while extrinsic actions have negative or chore-like experiences. In the context of loan repayment, the pleasant part is the consumption, making payments afterwards when the good feeling from the consumption is in the distant past is a chore. This makes delinquency an attractive option.

6. Consumer Loans and Personal Financial Management

The goal of personal financial management is to develop a process of using the person's money to achieve economic satisfaction (Kapoor, Dlabay, & Hughes, 2010, p 5). Personal economic satisfaction should be based on the individual or family resources and not on the ability to borrow. The current situation that allows individuals to consume based on their ability to borrow is not sustainable. All individuals start with no credit, followed by the establishment of a good credit. A good credit lasts only until it is over extended and it becomes a bad credit. The preceding discussion has focused on the misuse of credit by those who have poor personal financial management skills. Good personal financial management practice entails living within your means. Borrowing against future income to meet current consumption needs does not eliminate the need for future consumption. When the future arrives, the need to borrow increase as well as the amount borrowed. This is what happens when the expected future income does not materialize. Bankruptcy, with its negative effects, forces the bankrupt to do what they should have been doing in the first place: living within their means.

Nature follows the path of least resistance. The availability of easy credit encourages poor financial planning. It allows people to consume now and defer its cost to some future date. With easy credit, it is difficult to resist the allure of "fifty percent off"; "buy now and no payment for one year" and similar catch on phrases and advertising slogans. Given that the number of attractive ways available to spend money always exceeds the money that is available, consumers must exercise self-control and impose restraints on their own behavior to avoid the negative consequences of financial mismanagement (O'Curry, 2003). Consumers with good personal financial management habits use easy credit to acquire high-ticket items that are already line items in their budget. The money they have slated as saving towards the purchase of that item serves as a means of repaying the debt. It allows them to match the benefits of the items purchased to the payment stream required to retire the debt. This is investment spending. This is the appropriate use of credit. Personal consumption expenses like every other expense should be part of the period's budget, and supported by the current level of income. Emergency expenses should be a line item in the budget that serves to accumulate funds for such events. Speculative expenditure such as taking advantage of sales should be goal driven and as such be a line item in the budget that accumulates funds to take advantage of such opportunities as they present themselves. The key to this scenario is the belief that all expenses must be tied to a specified goal for which provision for its accomplishment has already been made in the budget. This is sound personal financial management. Unfortunately, the demographic group that is most prone to the abuse of credit does not have a budget. O'Curry (2003) reporting on a survey conducted by Nina Diamond and Sue O'Curry, found that the respondents saw a budget as an end rather than a means. They saw having too little money and having more money than one needed were reasons not to have a budget. The survey also showed that although the respondents believed in fiscal responsibility, their definition of fiscal responsibility was paying bills on time, even if the payments were just the minimum. Being debt free was not considered as being fiscally responsible. The survey also observed that respondents believe in the adage that "life is for living". Consequently, they believe that "limited means should not limit ability to consume things that are enjoyable and add meaning to one's existence". They believe in instant gratification and for the present. They see debt as a source of income without considering how to repay it. The behavior of this group necessitates the need for the reform of the credit card debt instrument.

Oil companies and merchants first introduced credit cards in the 1900s as a means of "creating customer loyalty and improving customer service". They have become the preferred means of payment for travel, entertainment, retail purchase, and bill payment (Sienkiewicz, 2001). Today, the credit card system also allows millions of people to live beyond their means, foregoing the discipline of saving to achieve their goals for instant gratification using signature loans

7. Recommendation and Conclusion

The problem with the current system is that easy credit has replaced financial discipline. Households no longer feel the need to have precautionary nest egg for emergencies; households no longer feel the need to save for high-ticket items. Their solution is to borrow and pay with uncertain future income. SW argues that over the life cycle of a typical household, variation in income is far greater than variation in spending or consumption. Thus, households have to rely on the financial markets to borrow and meet the seemingly constant consumption rather than adjusting consumption to fit income.

The solution to the credit crisis and high consumer indebtedness is an attitude adjustment. Easy credit should become outdated. Consumer credit and debt should be investment driven, not consumption. Consumer debt should be tied to consumer durables that provide services over an extended period and the payment for the debt is financed by reduction in the expenses normally used to cover the cost of the services now provided by the durable goods.

The use of credit card should return to its original intent: a convenient means of payment rather than a source of instant uncollateralized loan. Today every depository institution issues a debit card. The debit card performs all the functions of the credit card with one notable exception: it is not a loan. Every charge is based on the available funds in the owner's account. It is just as widely accepted as any credit card. It is gradually becoming the payment method of choice by many consumers. This is why banks like Bank of America and Wells Fargo are beginning to charge a fee for the use of their debit cards.

Moreover, the living within our means serves to increase future consumption because the reduction in the cost of capital and investment gains from the deployment of the savings created by reduced consumption today. Living within our means should not be interpreted as living within our ability to borrow. It will reduce the adverse selection and moral hazard created by high default-risk premium and its income redistribution effect. It will eliminate the practice of the many paying for the consumption of a few, a misapplication of the principle of insurance. It is time we learned to live within our means.

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Table 1. GDP and Savings Growth Rates

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Growth GDP Real (%)	1.1	1.8	2.5	3.5	3.1	2.7	1.9	-0.3	-3.5	3
Growth GDP Nominal (%)	3.4	3.5	4.7	6.4	6.5	6	4.9	1.9	-2.5	4.2
Savings Rate (%)	2.7	3.5	3.5	3.6	1.5	2.6	2.4	5.4	5.1	5.3

Adapted from Bureau of Economic Analysis

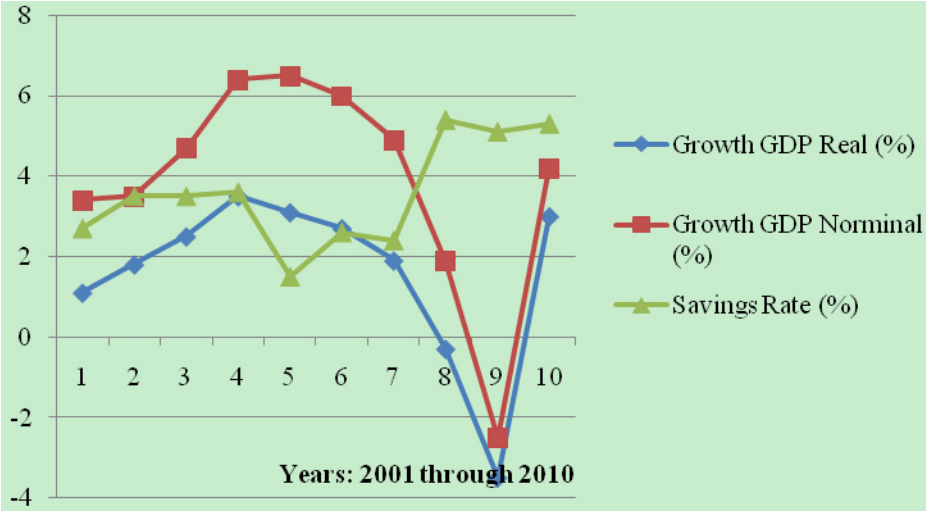

Figure 1. GDP and Saving Growth Rate