

It's Not OK for Finance to Be Dangerous Again

Consumers make mistakes out of ignorance. They need help, not a regulatory rollback.

By [Noah Smith](#)

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There's a reason this isn't scary. *Photographer: Ricardo DeAratanha/Los Angeles Times/Getty Images*

Suppose you have two loans. The first is a student loan of \$40,000 with an interest rate of 6 percent, and the second is a credit-card balance of \$12,000 with an interest rate of 11 percent. You find that at the end of each month, you have about \$1,000 left over, and you want to use it to pay down the principal on your debts. That's sensible. So how much do you put toward each loan?

The rational thing to do would be to pay off the 11 percent loan before even starting to repay the 6 percent loan. This isn't a matter of taste -- it's just simple math. After all, every dollar you spend paying down the credit card would otherwise be growing at 11 percent a year, which is faster than 6 percent a year. If you can, always pay down your debts starting with the highest interest rate.

But that's not what most people do. According to [new research](http://www.nber.org/papers/w24161) <http://www.nber.org/papers/w24161> by economists John Gathergood, Neale Mahoney, Neil Stewart and Joerg Weber, they instead tend to split their repayments between higher- and lower-interest debt. Gathergood et al.

looked at consumers in the U.K. who had two credit cards, who made their minimum payments on time, and who carried balances on both cards -- in other words, people who had enough money to pay down some of their debt at the end of each month.

The difference in interest rates between the two cards tended to be large -- 6.3 percentage points on average. This meant there's a big incentive to pay down the higher-interest one first. But the authors found that on average, after making their minimum payments, borrowers allocated only 51.5 percent of their extra payments to the higher-interest card. Only 10 percent of borrowers devoted all of their payment toward eliminating the more expensive debt.

Instead, Gathergood et al. found that many borrowers tended to allocate their extra payments in proportion to how big the balances are on each credit card -- if 70 percent of their debt is on the low-interest card and 30 percent on the high-interest one, they sent 70 percent of their repayment cash to the former and 30 percent to the latter. This behavior is known as balance matching.

There's really no good way to spin this behavior as rational. It could be that larger balances create more anxiety in people's minds, causing them to throw more money toward the bigger debt. Or people could be financially unsophisticated, and simply not realize they're leaving money on the table. Either way, the result is that borrowers end up poorer.

This brings us to the topic of the Consumer Financial Protection Bureau.

Created in 2010 as part of the Dodd-Frank financial reform, the CFPB is supposed to protect financial consumers from predatory lending practices and unsafe financial products. As Elizabeth Warren, now a senator from Massachusetts, [put it in 2007](https://democracyjournal.org/magazine/5/unsafe-at-any-rate/) :

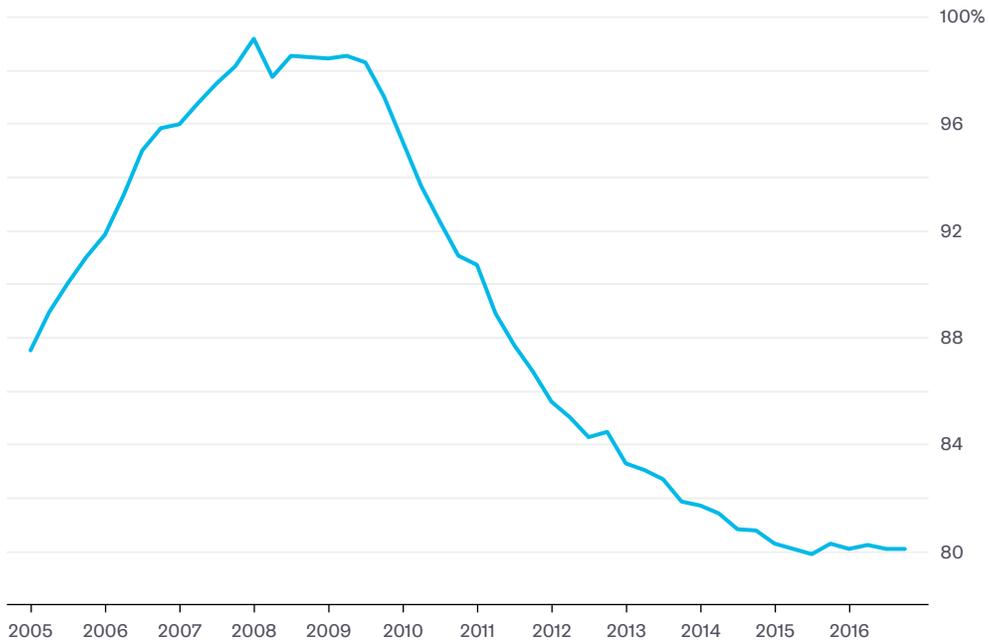
It is impossible to buy a toaster that has a one-in-five chance of bursting into flames and burning down your house. But it is possible to refinance an existing home with a mortgage that has the same one-in-five chance of putting the family out on the street. ... Why are consumers safe when they purchase tangible consumer products ... but when they sign up for routine financial products like mortgages and credit cards they are left at the mercy of their creditors?

Now, like many other parts of the government, the CFPB is under siege by the administration of President Donald Trump. Trump's method of attack follows a familiar pattern -- instead of abolishing the agency, he simply gave the CFPB [an interim director](https://thinkprogress.org/cfpb-protect-consumers-8d50e60ba5d6/) who despises the agency's intended mission and purpose. That director is Mick Mulvaney, who has called the agency he now captains "a joke...in a sick, sad way," and "an awful example of a bureaucracy gone wrong." Under Mulvaney, the agency [has modified](https://www.vanityfair.com/news/2018/01/elizabeth-warren-enraged-over-cfpb-orwellian-rebranding) its mission statement to include financial deregulation. It has also [implemented](https://www.theatlantic.com/business/archive/2018/01/cfpb-gop-trump/549755/) a freeze on hiring, rule-making and data collection.

This is [a bad time](http://thehill.com/opinion/finance/367246-nerdwallet-ceo-americans-need-the-cfpb-now-more-than-ever) to divert the CFPB from its original mission of protecting consumers. Though households are slightly less indebted than before the financial crisis, they still owe an amount equal to 80 percent of gross domestic product:

Deleveraging Is Over

House debt as a share of U.S. gross domestic product

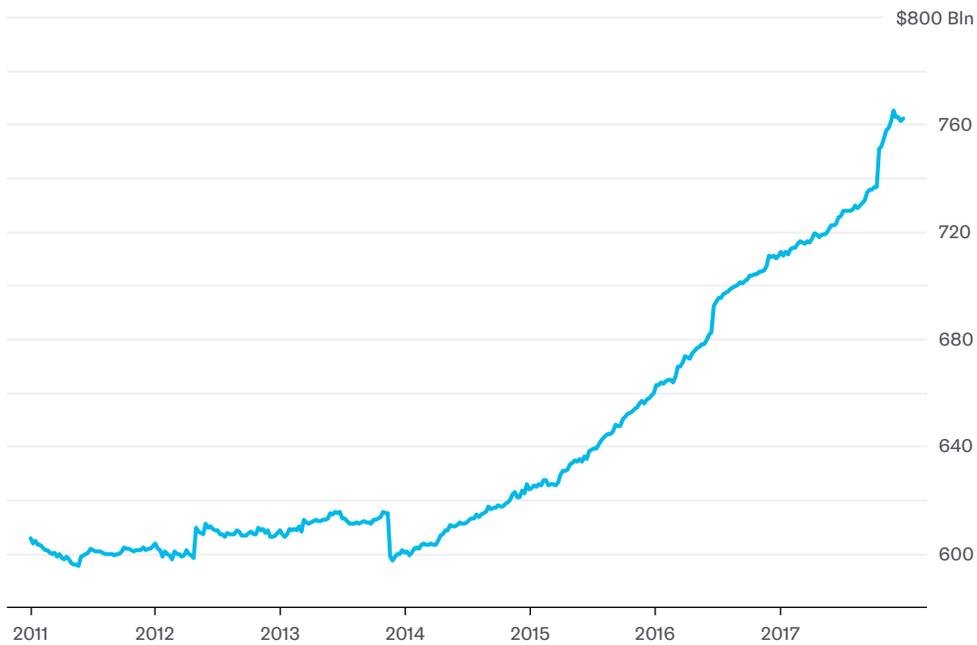


Source: Federal Reserve Bank of St. Louis

Meanwhile, credit-card debt continues to climb:

Plastic Is Hot Again

Credit card and other revolving loans by commercial banks

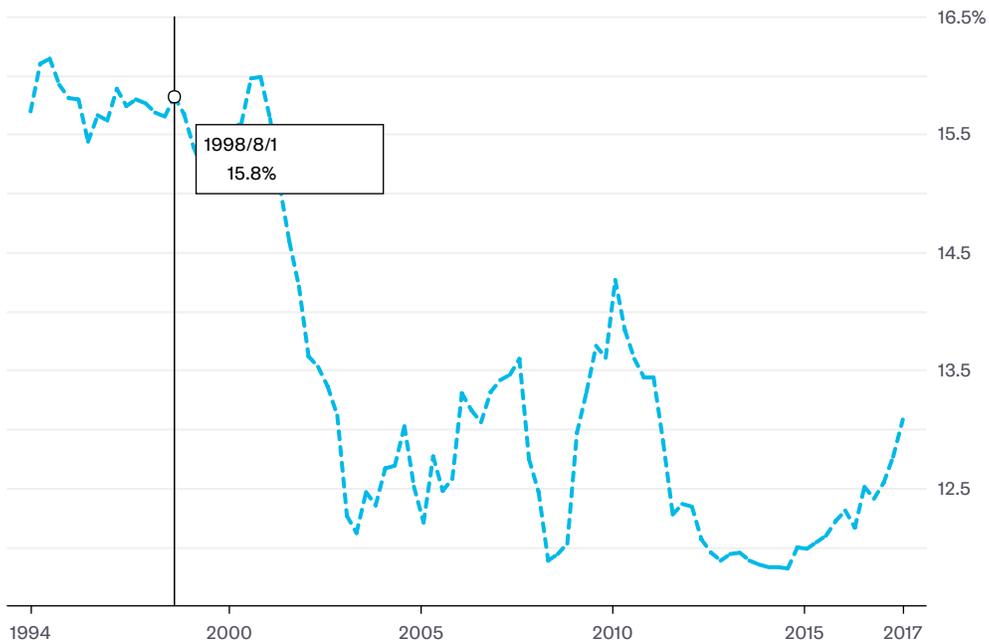


Source: Federal Reserve Bank of St. Louis

And although credit-card interest rates have come down, they still average about 13 percent:

Repay This Stuff First

Commercial bank credit-card interest rates



Source: Federal Reserve Bank of St. Louis

Meanwhile, student-loan debt is at record highs, reducing many households' ability to repay their credit cards, especially if they follow the suboptimal repayment behavior documented by Gathergood et al.

If anything, Gathergood et al.'s research -- and that of other economists <<https://www.bloomberg.com/view/articles/2016-07-12/the-profit-motive-behind-financial-complexity>> -- shows that the CFPB's mission needs to extend beyond merely protecting consumers from the kind of predatory lending practices that were common before the crisis. Financial literacy <<https://www.bloomberg.com/view/articles/2016-07-30/the-sorry-state-of-financial-literacy-in-the-u-s>> in the U.S. is extremely low. Let's hope the public-school curriculum can be modified to teach future generations how to manage money, but in the meantime, the CFPB is the only institution in the country that can help people better understand finance.

With leadership like Mulvaney's, it seems highly unlikely the agency will take on such a role. Although economists are finding more and more ways that consumers need more financial guidance, the government is moving in the opposite direction.

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