Discussion of Bond, Musto, and Yilmaz, “Predatory Lending in a Rational World”

○ Focus is rational predation:
  ● Lender knows more about borrower’s income distribution than borrower does – but borrower tries to infer this information from loan offer.
  ● Predation is when borrower takes offer she wouldn’t take if knew her (income) type.
  ● So predation requires pooling; otherwise, borrower would know if she were being exploited.

○ Predation and social welfare.
  ● Strong: gain to lender < loss to borrower (inefficient).
  ● Weak: gain to lender $ loss to borrower (efficient).

○ Predation and borrower income type.
  ● If “bad” borrower (below average chance of high income), predation results in excessive default and foreclosure.
  ● If “good” borrower, predation results in excessive loan payments.
Results

○ Predation of bad borrowers:
  ● Occurs when loss from foreclosure not too high and borrowers value their collateral more than consumption from loan.
  ● Can be strong or weak.
  ● More likely as loan size falls or as lender info quality falls.

○ Predation of good borrowers:
  ● Occurs when loss from foreclosure not too high and borrowers value their collateral less than consumption from loan.
  ● Always weak (if strong, bad borrowers would lose too, so no lending possible).

○ Competition undermines predation of bad borrowers, except when collateral fully protects lender.

○ Predation more likely if loan proceeds are used to buy collateral or to increase collateral’s value to borrower.
Related Literature

○ Excessive optimism and over-borrowing:
  ● Manove and Padilla (1999)
  ● Hanson and Morgan (2005)

○ Hyperbolic discounting and back-end loading of costs:
  ● DellVigna and Malmendier (2004)

○ Borrower difficulties in understanding loan terms:
  ● Engel and McCoy (2001)
  ● Richardson (2003)
  ● Willis (2005)
Contributions

○ Predatory lending in rational setting.

○ Nicely captures some features of predation in simple model where foreclosure is socially inefficient.

○ Link between predation, collateralized lending ties well to concerns about subprime auto loans in 1990s, subprime mortgages today.

○ Nice points on policy.
  - Community Reinvestment Act: promotes competition reduces predation.
  - Equal Credit Opportunity Act: forces pooling promotes predation, even with competition.
Concerns

○ Need clearer discussion of related literature. Models with bounded rationality lead to predation, as explored by a number of authors.

○ Not clear predation of concern is limited to excessive foreclosure due to lender’s superior knowledge of income type.
  ● Key concern of policymakers is borrower understanding of loan terms (“fine print”) – this is focus of NC’s law.
  ● Not all due to borrower naïveté; lenders misrepresent terms. See Richardson (2003).
  ● Can lead to excessive payments rather than excessive foreclosure – especially w/(unsecured) credit card loans.

○ Need clearer intuition in several parts, especially for comparative statics on loan size, description of lending rate regions.