Risky Business: Not as Endearing Today as it was Thirty Years Ago

Cliff A. Robb, Kansas State University[1]
Patryk Babiarz, University of Georgia[2]
Ann Woodyard, University of Georgia[3]
Martin C. Seay, Kansas State University[4]

Abstract

This paper investigated the use of high-cost alternative financial services (AFS) from the perspective of bounded rationality. Previous work investigating the relationship between financial knowledge and AFS use has been clouded by the inability to differentiate between the use of AFS as an optimal borrowing decision, and its use when other less costly options were available. Consequently, this research sought to isolate less than optimal borrowing decisions through repeated testing of sub-samples of individuals with characteristics that make them less likely to objectively need such products.

To better understand the roles that actual (objective) and perceived (subjective) financial knowledge play in the consumer decision-making process, respondents were grouped into 4 categories: those with high objective and high subjective knowledge (HO-HS), those with high objective and low subjective knowledge (HO-LS), those with low objective and high subjective knowledge (LO-HS), and those with low objective and low subjective knowledge (LO-LS). Using data from the 2009 and 2012 waves of the National Financial Capability Survey (NFCS), a series of logistic regression analyses were generated using restricted samples of individuals with positive financial characteristics. These characteristics included having an emergency fund, owning a home, having health insurance, reporting no difficulty in paying bills, having high credit scores, and having no medical or student loan debt.

Consistent results indicate that, in situations where objective need is limited, individuals with lower objective financial knowledge are significantly more likely to utilize AFS instruments. Furthermore, results indicate that individuals with low objective financial knowledge and high subjective financial knowledge (determined based upon sample medians) are most prone to use AFS products. Overall, results indicate that borrowers may be limited by bounded rationality, leading them to make less than optimal borrowing decisions. Consequently, AFS products, rather than serving a population with no other options, may be reaping benefits from less financially knowledgeable households.

[1] Associate Professor, School of Family Studies and Human Services, Kansas State University, Manhattan, KS, USA. Phone: 785-532-1940. Email: cliffrobb@k-state.edu.
[2] Assistant Professor, Department of Financial Planning, Housing and Consumer Economics, University of Georgia, Athens, GA, USA. Phone: 706-542-4138. Email: pbabiarz@uga.edu.
[3] Assistant Professor, Department of Financial Planning, Housing and Consumer Economics, University of Georgia, Athens, GA, USA. Phone: 706-542-4851. Email: awoodyrd@uga.edu.
[4] Assistant Professor, School of Family Studies and Human Services, Kansas State University, Manhattan, KS, USA. Phone: 785-532-1486. Email: mseay@k-state.edu.

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