Contract Pricing in Consumer Credit Markets

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Abstract. We study pricing and contract design in the subprime auto sales market. We develop a model of the demand for financed purchases that incorporates both adverse selection and moral hazard effects, and estimate the model using detailed transaction-level data. We use the model to quantify selection and repayment problems and show that different contracting terms, in particular car price and required down payment, resolve very different pricing trade-offs. We also evaluate the returns to credit scoring that allows sellers to customize financing terms to individual applicants. Our empirical approach shows how standard tools for analyzing demand and supply in traditional product markets extend to contract markets where agreement and performance are separated in time, so firms care about both the quantity and quality of demand.

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