Prepared Testimony of

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of the Committee on the Judiciary

of the United States House of Representatives

Hearing on Consumer Bankruptcy Issues

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Biographical Information

Lawrence M. Ausubel is Professor of Economics at the University of Maryland at College Park. He received his A.B. from Princeton University in 1980 and his Ph.D. in economics from Stanford University in 1984. He is the author of "The Failure of Competition in the Credit Card Market" (*American Economic Review*, March 1991), which is generally considered the best-known article on credit cards in the economics literature. He has also written a 1995 working paper, "The Credit Card Market, Revisited," and the entry on "Credit Cards" in the *New Palgrave Dictionary of Economics*. More recently, he has studied the recent upsurge in personal bankruptcies. He is the author of "Credit Card Defaults, Credit Card Profits, and Bankruptcy" (*American Bankruptcy Law Journal*, Spring 1997), which he wrote for presentation at the National Conference of Bankruptcy Judges. This article was recently awarded the Editor's Prize for the best article in the *American Bankruptcy Law Journal* in 1997. He has testified on this subject before the U.S. Senate Subcommittee on Financial Institutions and Regulatory Relief in February 1998, and before the National Bankruptcy Review Commission in January 1997.

Disclosure of Federal Grants, Contracts, or Subcontracts

Professor Ausubel was the principal investigator on National Science Foundation Grant SBR-94-10545 to the University of Maryland, October 15, 1994 - September 30, 1997, for $167,737. The grant, entitled "Bargaining Power, Sequential Recontracting, and the Principal-Agent Problem," pertains to bargaining theory. He is also the principal investigator or co-principal investigator on two pending National Science Foundation grants on auction theory, which he has been verbally told will be awarded in the current fiscal year (but have not yet been awarded). The subject matter of these grants bears no relation to the topic of the current hearing.

EXECUTIVE SUMMARY

1. All available statistical evidence points to the record level of household debt as the immediate cause of the record number of personal bankruptcies. In turn, there are numerous factors behind the rise of household debt, but one of the most important is the high rate of profit associated with consumer credit and the corresponding incentives for aggressive lending.

2. Some lender organizations have recently proposed a broad restriction on access to bankruptcy protection, self-styled as "needs-based bankruptcy," which has been incorporated into several bills recently introduced into Congress, including H.R. 2500, H.R. 3150, and S. 1301. These bills are substantially misdirected and, if adopted, would likely lead to a generally-worsened social outcome in two respects. First, these bills represent a substantial retreat from the traditional bankruptcy objective of allowing the debtor a "fresh start," and as such, are subject to the economic arguments underpinning the fresh start doctrine. Second, to the extent that these bills would increase the expected profitability of lending to marginal customers, they would lead to more lending to such customers and hence to an increase — rather than a decrease — in the incidence of overextended consumers.

3. It seems preferable to follow the general approach of H.R. 3146, which attempts to limit credit overextensions by restricting the claims of lenders who cause unsecured debts to exceed 40 percent of the debtor's annual income. At the same time, a more comprehensive solution could be attempted by instituting "strict time priority" on unsecured debts. Under current law, later lenders impose risk on earlier lenders, since additional lending increases the probability that the original debt is defaulted upon. Strict time priority would establish a rule that, under bankruptcy, available resources would go to fully repay earlier (unsecured) lenders before later (unsecured) lenders receive any repayment at all. Thus, creditors would be given every incentive

to be more cautious about lending the additional balances which might push consumers over the edge into bankruptcy.

4. Most of the consulting reports which purport to demonstrate the benefits of the lender bankruptcy bills make two basic errors, which render their conclusions almost irrelevant to the current policy debate. First, the consulting reports assume that lender behavior will remain unchanged in a world where bankruptcy protection is limited, leading to the questionable conclusion that the bills will reduce the costs of bankruptcy. They ignore that lenders are likely to offset the tightened bankruptcy access with still more aggressive lending. Second, the consulting reports assume that the savings from restricted bankruptcy protection will get passed along, on a one-to-one basis, to consumers. They forget that all empirical evidence on the credit card market has been that most cost savings are kept by lenders, rather than getting passed through to consumers. The most likely effect of restricting bankruptcy protection is merely a windfall gain in profits for lenders, and little or no benefit to consumers.

PREPARED TESTIMONY

Mr. Chairman and members of the Subcommittee, I am honored by the invitation to appear before you today. This hearing, I understand, is concerned with the record level of personal bankruptcies, its causes, its costs, and proposed legislative solutions. I hope that my input is helpful to your discussions of bankruptcy reform.

1. PERSONAL BANKRUPTCIES AND THE HOUSEHOLD DEBT BURDEN

The number of personal bankruptcies exceeded one million for the first time in 1996, and reached more than 1.3 million in 1997. What is responsible for the record level of bankruptcies?

All available statistical evidence points to the record level of household debt as the immediate cause. At the macro level, the ratio of household debt to disposable personal income correlates closely with the rate of personal bankruptcies. At the micro level, the amount of revolving credit outstanding is a strong predictor of whether a given individual will file for bankruptcy.

Figure 1 illustrates the time trend of personal bankruptcies and the household debt burden. In 1984, aggregate American household debt (consumer credit outstanding + mortgage debt) equaled 58.0% of aggregate American disposable personal income. By the third quarter of 1997, the household debt had mushroomed to 83.5% of disposable personal income. Along the way, changes in the rate of personal bankruptcy filings fairly closely tracked changes in the household debt burden, with changes in the debt burden leading changes in bankruptcy filings by several quarters.

Happily, the statistical relationship between the household debt burden and personal bankruptcies suggests that the growth in bankruptcy filings should markedly slow in 1998. The ratio of debt to disposable income increased at roughly only half the rate in 1997 that it did in the preceding three years. This leads to the prediction that bankruptcy filings should rise at a markedly slower rate in 1998 than they did in 1995, 1996 and 1997. At the same time, we should not become overly sanguine about the expected plateau in 1998; it is clear from historical experience that when we enter the inevitable next economic recession, consumer defaults and personal bankruptcies are likely to reach new record levels.

A. The Rise in the Household Debt Burden

If the long-term rise in the bankruptcy rate is caused by the rise in household debts, we now need to go back a step and examine what is responsible for the rise in the household debt burden. Consumer advocates would have us believe that the rise in the debt burden is importantly due to the increasingly-aggressive marketing efforts of lenders. The credit industry has replied that the long-term rise in housing prices has importantly contributed to a long-term rise in mortgage debt, which is the largest component of household debt. In my professional opinion, both of these claims are correct.

My own research has found that, since 1983, credit card lending has been one of the most profitable areas of banking. This has created strong incentives for credit card issuers to assertively expand the sizes of their portfolios, and is reflected in extremely large volumes of direct-mailed preapproved credit card solicitations. As illustrated in Figure 2, the volume of credit card solicitations was “only” 453 million in the second quarter of 1993, shortly before the recent run-up in debt and bankruptcies. During the ensuing three years, the volume of solicitations typically hovered around 700 million per quarter and, following a temporary dip in late 1996 - early 1997, reached a record 881 million in the second quarter of 1997. It is useful to recognize that the figure of 881 million solicitations in a quarter translates to an average of about 9 direct-mailed solicitations in a 13-week period per American household — creditworthy or not.

At the same time, it would seem like a case of statistical overkill to say any more than a few words about the long-term rise in American housing prices and its obvious contribution to the rise in mortgage debt. In particular, this is surely a significant contributor to the rise in the ratio of household debts to disposable personal income in the 1980’s — although it is not necessarily an important factor in the 1990’s, when the housing market has been closer to flat.

B. A Few Comments on Statistical Issues

Before proceeding ahead with an analysis of the lender proposals for bankruptcy reform, it is worth clarifying a few statistical issues concerning the link between bankruptcy filings and the household debt burden. First, a recent report by MasterCard International maintains that the aforementioned ratio of household debt to disposable personal income now overstates the debt burden of the household sector, as credit cards are being substituted for cash and checks as a method of payment. However, the numbers which are displayed in Figure 1 specifically exclude convenience use of credit cards (including only the portion of revolving credit which is rolled over from month to month), yet they still display the well-known sharp increase. Moreover, it may be argued that other components of the standard consumer credit data now understate the debt burden of the household sector, as there has been a fair amount of substitution from auto loans (which are included as consumer credit) to auto leases (which apparently do not show up on the household balance sheet).

Second, although a substantial part of the run-up in mortgage debt merely reflects an increase in housing prices, it would be incorrect to exclude mortgages from our debt burden calculations. This is because there has also been a fair amount of substitution from credit card loans (which are included as consumer credit) to home equity loans (which are a component of mortgage debt); excluding mortgage debt thus might substantially understate the growth of household borrowing in the 1990’s.

Third, the credit industry has emphasized the role of such other factors as medical emergencies, marital breakups, gambling, and reduced stigma associated with bankruptcy in the recent record levels of bankruptcy. While each of these other factors undoubtedly plays some role here, I am not aware of any convincing statistical evidence that these factors are especially important.

Finally, in my opinion, the statistical view which I am presenting here is as close as we have to a consensus view today. For example, it accords generally with the testimony of Kim J. Kowalewski, Chief of Financial and General Macroeconomic Analysis at the Congressional Budget Office, before the National Bankruptcy Review Commission in January 1997. Kowalewski also emphasized that there has been a fairly close correlation between the household debt burden and personal bankruptcy filings over a 35-year period. It also accords generally with a recent study by Paul Paquin and Melissa Squire Weiss of Capital One Financial Corporation (one of the largest issuers of MasterCard and Visa cards in the United States). Paquin and Weiss conclude that 98% of the variation in the personal bankruptcy rate during 1987-96 can be explained by four factors: the growth in the number of bankcard accounts; the household debt-to-income ratio; initial unemployment claims; and the one-year Treasury bill rate.

2. Economic Analysis of Lender Bankruptcy Bills

A. Retreat from a Fresh Start

Some lender organizations have recently proposed broad restrictions on bankruptcy protection. Their proposal, self-styled as "needs-based bankruptcy," has been incorporated into several bills recently introduced into Congress, including H.R. 2500, H.R. 3150, and S. 1301. These bills would have the effect of forcing many debtors, who are currently eligible for Chapter 7 bankruptcy filings, into Chapter 13 filings. In my professional opinion, these bills are substantially misdirected and, if adopted, would likely lead to a generally-worsened social outcome in two respects. First, these bills represent a substantial retreat from the traditional bankruptcy objective of allowing the debtor a "fresh start," and as such, are subject to the economic arguments underpinning the fresh start doctrine. Second, to the extent that these bills would increase the expected profitability of lending to marginal customers, they would lead to more lending to such customers and hence to an increase — rather than a decrease — in the incidence of overextended consumers. This section of my testimony will focus on the fresh start issue and the next section will focus on the unintended consequence of greater debt.

One of the traditional purposes of personal bankruptcy relief is to relieve the honest but insolvent debtor of oppressive indebtedness and to permit a "fresh start." The economic argument for allowing a "fresh start" is precisely the same as the economic argument for reducing marginal income tax rates. Congress has favored low marginal tax rates in the 1980's and 1990's on account that high marginal tax rates create disincentives for productive activity. This argument states that any individual who faces a high marginal tax rate is provided with bad incentives in the labor-leisure choice: if the government is going to take a high fraction of the individual's wages as taxes, then it may not make sense for the individual to work hard and earn high wages. Moreover, to the extent that the marginal tax rate becomes punitively large, the individual is given strong incentives to go "off the books" completely, working for cash in the underground economy.

Precisely the same logic applies to the overextended debtor. The required repayment rate to creditors takes exactly the same role as a high marginal tax rate. Suppose that debts get so out of hand that essentially all of an individual's earnings, above subsistence and taxes, must go toward the repayment of creditors. Then it may not make sense for the individual to work hard and earn high wages, and the individual may be tempted to go off the books completely, working for cash in the underground economy. Chapter 7 bankruptcy is the escape hatch which provides the overextended debtor an opportunity to have a fresh start, with restored incentives for hard work and participation in the mainstream economy.

The so-called needs-based bankruptcy is little more than a sharp retreat from the fresh start doctrine. As I understand H.R. 3150, the insolvent individual who is forced into a Chapter 13 repayment plan may find himself facing income taxes and repayment requirements totalling close to 100% of his marginal income, for up to a five-year period. The disincentives for hard work, and the incentives to go off the books, may become paralyzingly large. Given the close similarity between the low-tax-rate and fresh-start arguments, it would seem particularly unfortunate for Congress to enact such a high "effective tax rate" for the members of society whose balance-sheets are the most strained, so soon after reducing (capital-gains) tax rates for the members of society whose balance-sheets are the most flush with assets.

Finally, observe that this economic argument for the fresh start doctrine only argues that debts should be wiped clean; it does not in any sense support the notion that individuals should be able to protect substantial amounts of assets under bankruptcy. Thus, I would strongly support the various proposals for limiting the homestead exemption, and for preventing individuals from shifting their assets into protected categories in advance of filing for bankruptcy.

B. UNINTENDED CONSEQUENCES OF THE LENDER BANKRUPTCY BILLS

The basic explanation behind today's omnipresent credit-card marketing and high credit-card default rates is the high rate of profitability on lending: the typical credit card interest rate today is 15.6%, according to Federal Reserve statistics; meanwhile, the cost of funds is but 6.0%. In an environment in which the spread between revenues and costs is so large as to yield extranormal profits, each firm has the incentive to invest extraordinary resources toward obtaining new customers. In the case of the credit card market, an issuer can easily justify large marketing expenditures and tolerate a large amount of default risk in its customer base.

Since 1983, credit card lending has been one of the most profitable areas of banking. My earlier research documented that credit card lending earned three to five times the ordinary rate of return from banking activities, during the period 1983-93. The profitability of credit card lending and other banking activities are compared in Figure 3. While direct data concerning the profitability during the post-1993 period is unavailable, strong indirect evidence of continuing extranormal profits can be obtained from examining the stock market performance of the great monoline credit card issuers — First USA Incorporated, the MBNA Corporation, and Capital One Financial Corporation. The total return on shares of First USA, from its initial public offering in May 1992 through its acquisition by Banc One in the Spring of 1997, equaled 2,100 percent; by comparison, the total return on the S&P 500 equaled 132 percent during this same period. The total return on shares of MBNA, from its initial public offering in January 1991 through the present, equaled 1,800 percent; by comparison, the total return on the S&P 500 equaled 284 percent. The total return on shares of Capital One, from its initial public offering in November 1994 through the present, equaled 330 percent; by comparison, the total return on the S&P 500 equaled 142 percent. All of these calculations assume that dividends were reinvested.

The lender proposals for so-called "needs-based bankruptcy" can be typified as a restriction on bankruptcy protection for credit card debt and other unsecured lending. All else being equal, these proposals would increase the expected profitability of lending to marginal customers. As such, they would lead to the unintended consequence of still more lending to marginal customers and hence to an increase — rather than a decrease — in the incidence of overextended consumers.

Let us see, in some detail, how this unintended consequence plays out. In Figure 4, we begin with a supply curve (denoted S) and a demand curve (denoted D) for unsecured credit.

What is the likely effect of the proposed limitations on bankruptcy protection, on the supply curve? Lenders should be expected to rationally recognize that their probability of loss has been reduced by the change in law and, thus, they should be willing to lend increased quantities of unsecured debt at any given price (e.g., interest rate). Thus, we should anticipate an outward shift in the supply curve, from S to S′, in Figure 4.

What is the likely effect of the proposed limitations on bankruptcy protection, on the demand curve? Consumers should be expected to exhibit very little change in their borrowing behavior, for at least two reasons. First, unlike lenders, many consumers will fail to learn (at the time they are borrowing) about fairly technical changes in the bankruptcy law. Second, even to the extent that consumers do learn of the change in the law, experience strongly suggests that consumers will fail to act on the information. Just as many consumers may systematically underestimate the extent of their current and future credit card borrowing, it should be expected that many consumers may systematically underestimate (at the time they borrow) the probability with which they will eventually fall into bankruptcy. Many or most consumers will underestimate the likelihood that they will become insolvent, and hence they will underreact to the reduction in bankruptcy protection. Thus, we should anticipate only a minimal shift in the demand curve, from D to D′, in Figure 4.

Let us now see the likely effects of the proposed limitations on bankruptcy protection in the market for unsecured credit to marginal customers. The original equilibrium (i.e., the intersection point of S and D) corresponds to a price of p and a quantity of q in Figure 4. As we have seen above, the supply shift (i.e., the increase in the willingness of lenders to issue credit to marginal customers at a given price) may be substantial. The corresponding demand shift (i.e., the corresponding decrease in the willingness of marginal customers to accept credit at a given price) is fairly negligible and fails to offset the supply shift. Thus, the new equilibrium (i.e., the intersection of S′ and D′) is associated with a somewhat lower price, *p′*, than the original equilibrium. However, due to the greater magnitude of the supply shift than the demand shift, the new equilibrium is also associated with a higher quantity, *q′*, of unsecured credit than the original equilibrium.

As depicted in Figure 4, it should be anticipated that the quantity effect will be more substantial than the price effect. The intuition for this prediction is that lenders will act on the change in bankruptcy law, whereas consumers will substantially fail to act. As a result, lenders will increase the pace of solicitations and credit line expansions, while marginal consumers should not be expected to neutralize this effect by declining the lenders' offers.

Paradoxically, we conclude that the likely effect of limiting bankruptcy protection for unsecured debt is an *increase* in the outstanding balances of marginal consumers. In our efforts to curtail the incidence of delinquency and default, we only *increase* the frequency with which consumers are buried under mountains of debt.

3. Strict Time Priority on Unsecured Debt

H.R. 3146 proposes a very different approach to bankruptcy reform. The bill proposes to limit credit overextensions by restricting the claims of lenders who cause unsecured debts to exceed 40 percent of the debtor's annual income. This approach is to be commended, as it attempts to go beyond the symptom of consumer bankruptcy, and to address one of the causes.

At the same time, I would like to take this opportunity to urge that a more comprehensive solution could be attempted by instituting "strict time priority" on unsecured debts. Generally speaking, under current law, if a consumer who files for bankruptcy has $20,000 in unsecured debt and only $10,000 available to repay it, all unsecured creditors will receive 50 cents on the dollar. It makes no difference that the first $10,000 in unsecured debt may have been a relatively prudent loan but that the second $10,000 in debt may have been a deliberately risky proposition. In other words, later lenders impose risk on earlier lenders, since additional lending increases the probability that the original debt is defaulted upon, yet the later lender has equal claim on assets as the earlier lender. This is both unfair to cautious earlier lenders, as well as a prescription for credit overextension to occur.

By strict time priority, I mean the establishment of a rule that, under bankruptcy, available resources would go to fully repay earlier (unsecured) lenders before later (unsecured) lenders receive any repayment at all. In the previous example, the creditor who advanced the first $10,000 would be repaid in full, while the creditor who extended the second $10,000 would receive nothing. Thus, creditors would be given every incentive to be more cautious about lending the additional balances which might push consumers over the edge into bankruptcy.

Observe that, under H.R. 3146, if the debtor in this example has an annual income of $50,000 or more, the 40% threshold is not crossed, and so the incentive problem of lenders is not addressed. Full time priority would solve this incentive problem.

Institution of strict time priority for unsecured debt is a reform on which, I believe, all sides of the bankruptcy debate might agree. As already stated, the proposed rule of H.R. 3146 is essentially a special case of time priority. Consumer representatives are likely to agree that most debtors who file for bankruptcy are unfortunates who became overextended on credit, and time priority would give lenders greater incentive to limit overextensions. At the same time, the lending industry is likely to agree that risky lenders may be harmful to prudent lenders, and time priority would help to remedy the incentive problem.

4. COMMENTS ON THE CONSULTING REPORTS

The recent discussion of the lender bankruptcy bills has spawned a cottage industry of consulting reports, paid for by the credit industry, and purporting to demonstrate the benefits of the bankruptcy bills. Most of these consulting reports make two basic errors, which render their conclusions almost irrelevant to the current policy debate. First, the consulting reports assume that lender behavior will remain unchanged in a world where bankruptcy protection is limited, leading to the questionable conclusion that the bills will reduce the costs of bankruptcy. However, as we have seen in the previous discussion, tightened bankruptcy access is likely to lead to the unintended consequence that lenders will make more loans to already-overextended consumers. Thus, increased lending is likely to substantially offset any improved ability of lenders to collect. As a consequence, there is no reason to expect the reductions in bankruptcy costs which the consultants forecast.

Second, the consulting reports assume that any savings from restricted bankruptcy protection will get passed along, on a one-to-one basis, to consumers. However, if you examine the credit card market from the early 1980's through the early 1990's, you find that the cost of funds dropped by 7 to 10 percentage points, while the interest rates charged consumers dropped only a small fraction of that. You also find that during the past few years, the cost of bankruptcies to credit card issuers has substantially increased while the interest rates charged consumers have increased barely, if at all. There is no empirical basis for arguing that a reduction in bankruptcy losses will get passed through to consumers. The most likely effect is merely a windfall gain in profits for lenders, and little or no benefit to consumers.

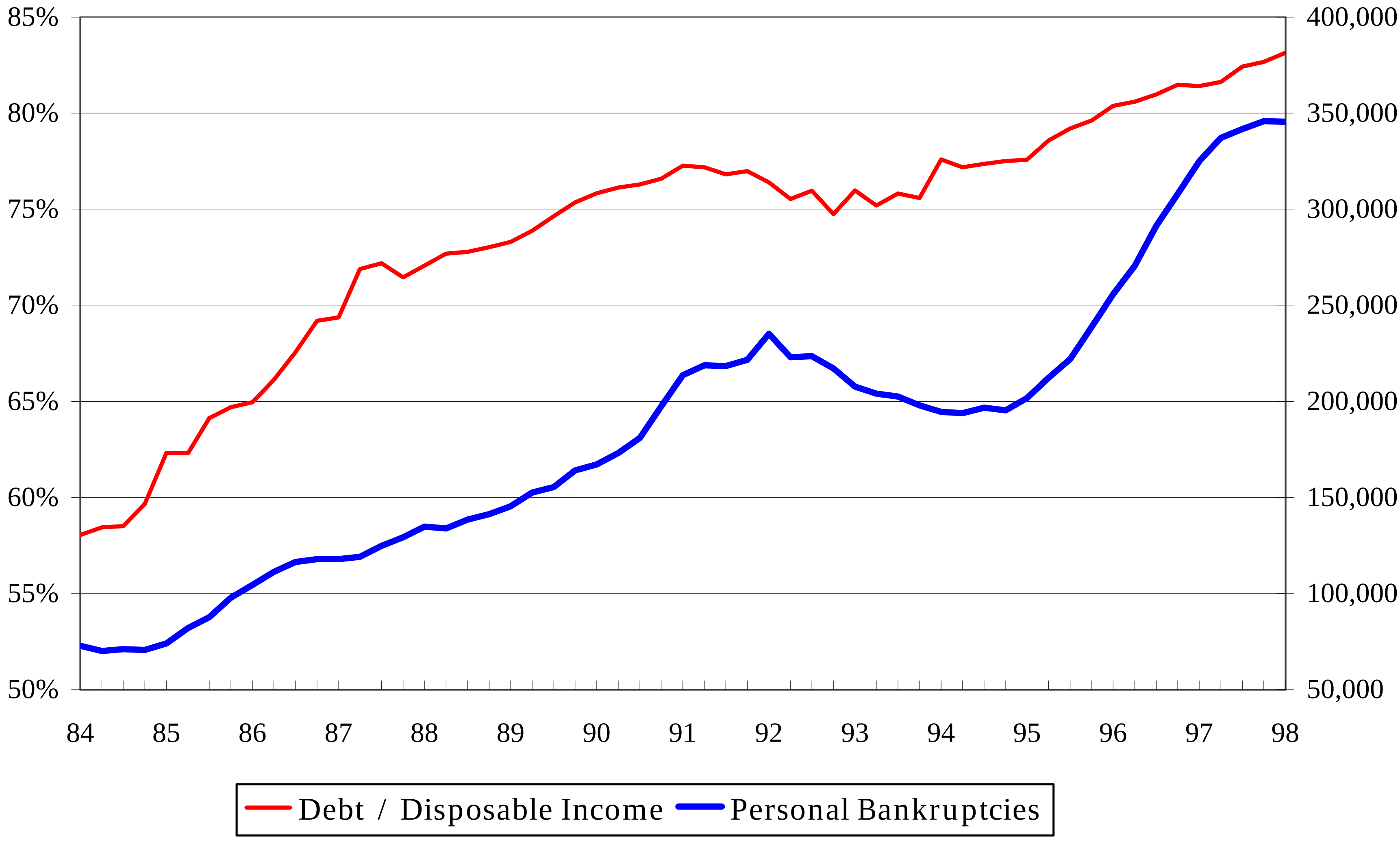
5. Conclusion

Consumer delinquencies and personal bankruptcies moved in tandem and both have repeatedly attained record levels in recent years. Their movement together has led some to attribute the increases in consumer defaults to a perceived leniency in the current bankruptcy law and to advocate restrictions in bankruptcy protection. However, this view appears to confuse the direction of causation and more importantly to misperceive the social problem at hand.

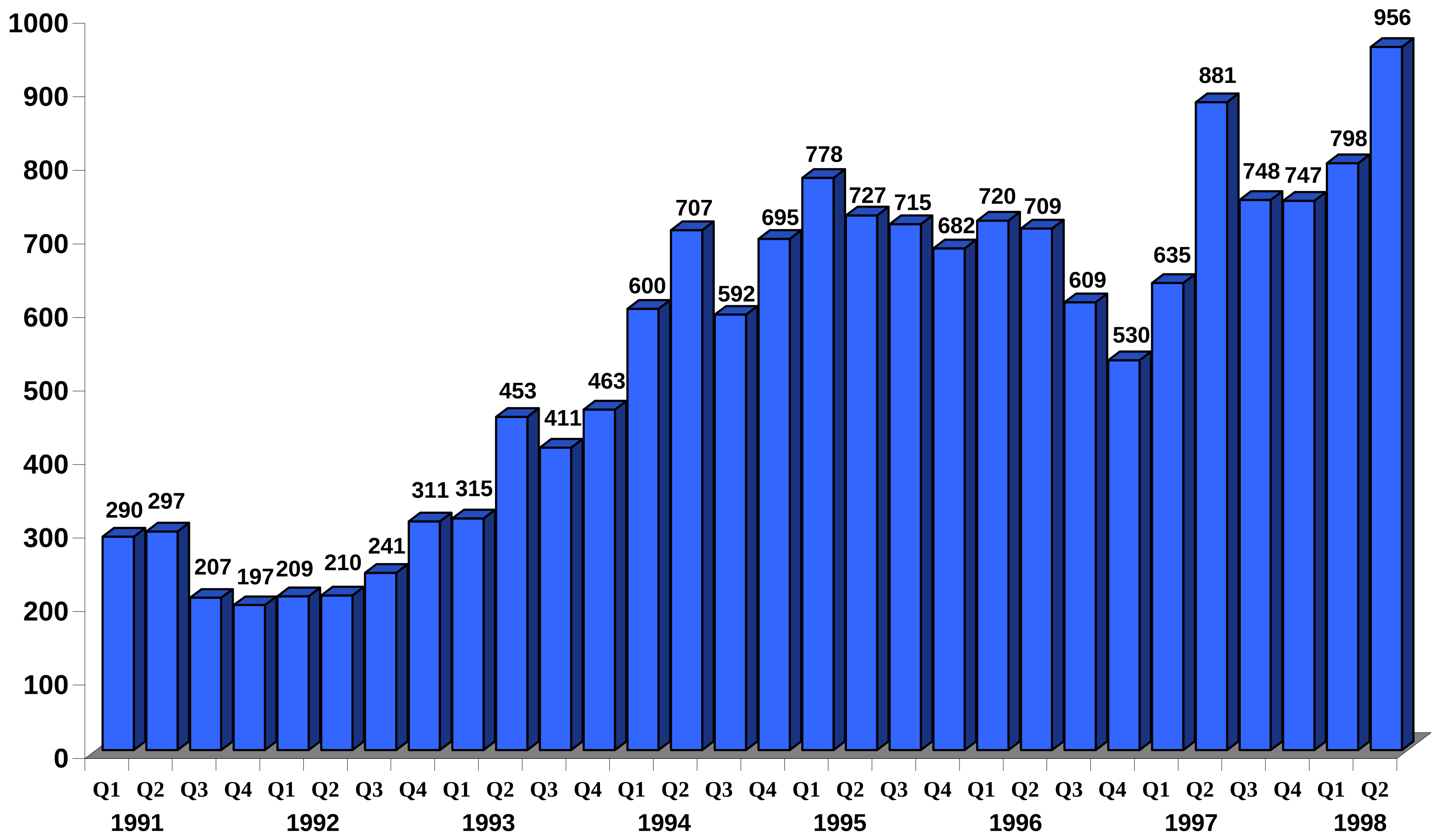
The social problem is not so much the rise in personal bankruptcies as the rise in overextended consumers. Many recent proposals to restrict bankruptcy protection overlook this simple fact and naively equate restrictions on bankruptcy with social improvement. In particular, the so-called "needs-based bankruptcy" proposal represents a sharp retreat from the notion of a "fresh start" under bankruptcy, and would likely lead to severe incentive problems much akin to those created by extremely-high marginal tax rate. Moreover, the new restrictions on bankruptcy protection would likely yield unintended consequences, probably only worsening the problem of consumer overextension.

Some simple bankruptcy reforms would clearly be beneficial, such as overhauling the system of exemptions which enables some individuals to abusively shelter their assets while having their debts discharged. In addition, I have argued that establishing strict time priority on unsecured debts would help to align lender incentives with society's interests. Bankruptcy reform should be directed toward discouraging overextension from occurring in the first place, while preserving the availability of bankruptcy protection and a fresh start in the event that such overextension occurs and becomes overwhelming.

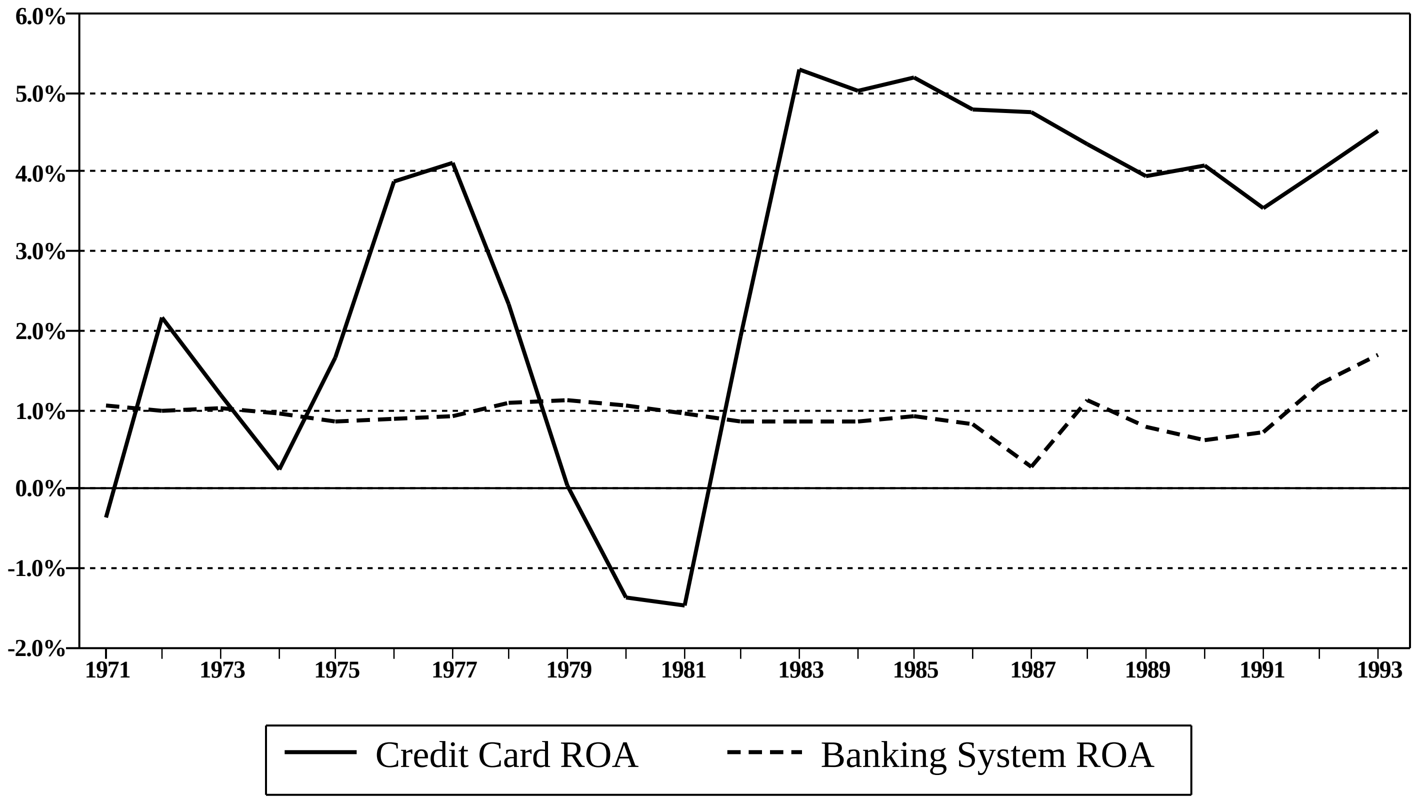
Household Debt Burden and Personal Bankruptcy Filings, 1984-98

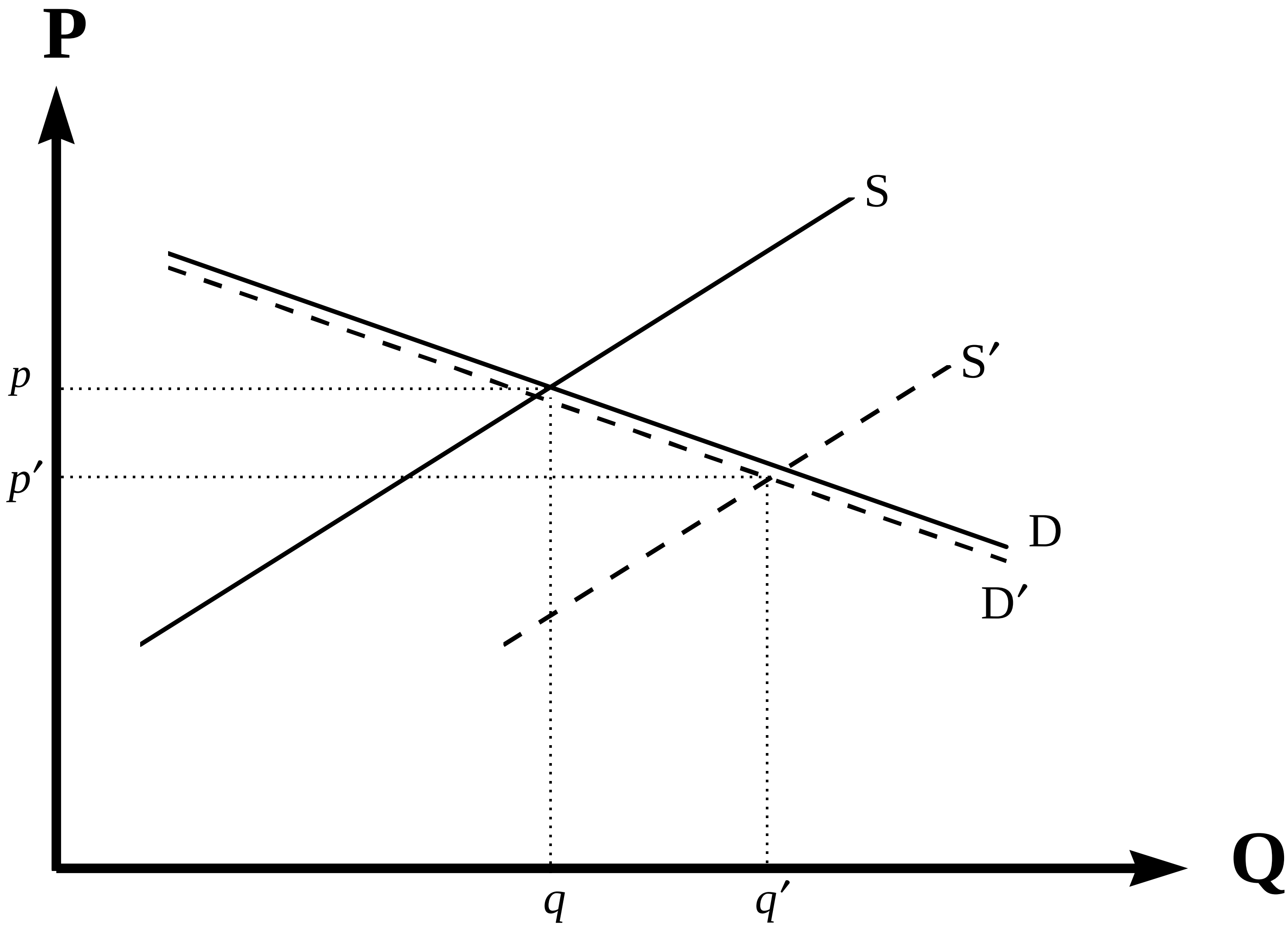


Credit Card Solicitations Mailed, in Millions per Quarter, 1991-98



Profitability of Credit Cards vs. Profitability of Overall Banking System

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