

OPTIMIZING CONSUMER CREDIT MARKETS AND BANKRUPTCY POLICY

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Abstract

The link between consumer credit markets and bankruptcy policy is a complex one, acknowledged but not adequately examined in the existing scholarship. This essay argues that the causative relationships running between borrowing and bankruptcy compel a different strategy for policing the conduct of lenders and borrowers in consumer credit markets.

I begin by sorting out some of the realities of consumer lending that policy debates about bankruptcy “reform” have obscured. First, I discuss the empirical link between credit card use, on the one hand, and increased consumer spending and financial distress. That link suggests that the ability of transacting parties to externalize the costs of financial distress contributes to the

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steadily increasing use of credit cards. Second, I argue that there is no evidence that the relatively liberal discharge available in the United States has led to abusive borrowing and spending. Third, I discuss the evidence that suggests that a more accessible bankruptcy discharge relates to an increase in entrepreneurial activity, with the associated positive spillover effects.

The essay then turns to consumer credit regulation. Generally, it argues that usury reforms have only a limited prospect for success, largely because of their inability to distinguish between value-increasing and value-decreasing transactions. Thus, I argue instead for two alternate approaches. The first would be to impose mandatory minimum payments on credit card contracts. Experience in the market suggests, albeit tentatively, that this will cause some marginal reduction in the amount of borrowing and lead to faster termination of open-ended borrowing contracts by those most likely to default. The best approach, I argue, would be a tax on distressed debt, particularly defaulted credit-card debt, which would have the salutary effect of internalizing some of the costs of those transactions on a party well placed to limit their occurrence.

Finally, the essay turns to bankruptcy theory. Here, the essay challenges the assumption of existing work that the purpose of bankruptcy policy should be to alter the incentives of borrowers to avoid financial distress and bankruptcy. Rather, I contend, the task is to allocate the losses between borrowers and lenders in a way that minimizes the net externalized costs of financial distress. Generally, I argue that this calls for rules placing more risks on lenders, so that they will have an incentive to use the information technology at their disposal to limit the costs of distress. The specific legal rule I recommend to further that end would be to subordinate the bankruptcy recoveries of adjusting, controlling creditors (credit-card lenders in the modern American example). I close by comparing the implications of my analysis with a few of the most salient provisions of the Bankruptcy Abuse and Consumer Protection Act of 2005, which are largely inconsistent with the concerns I raise.

OPTIMIZING CONSUMER CREDIT MARKETS AND BANKRUPTCY POLICY

I. INTRODUCTION

It is not novel to claim an inextricable link between consumer credit markets and bankruptcy policy. It is, still, a challenge to understand the nature of the link and the implications it holds for policymakers. Each of the many perspectives from which that link can be examined suggests something different. For example, prominent economic analysts have explored the likelihood that expansion of the bankruptcy discharge can both increase the demand for credit and decrease the supply.¹ Parallel work has considered the effect of bankruptcy exemptions on the supply and demand for credit.² An important problem for either analysis, underscored by Tom Jackson, has been the likelihood that quasi-rational behavioral biases of consumers undermine the policy prescriptions one might draw from models focused on fully rational consumer actors.³

Historical and political economic perspectives, in contrast, focus on the possibility that the expansion of the supply of credit necessitates a broader discharge. For example, several writers have pointed out the progression from relaxation of consumer credit regulations in much of western Europe in the 1980s, to increased financial distress by

¹ Barry Adler, Ben Polak & Alan Schwartz, *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. Legal Stud. 585 (2000).

² Michelle J. White, *Bankruptcy and Consumer Credit in the U.S.* (unpublished 2005 manuscript) [hereinafter White, *Bankruptcy and Consumer Credit*]; Michelle J. White, *A General Model of Personal Bankruptcy: Insurance, Work Effort, Opportunism and the Efficiency of the 'Fresh Start'* (unpublished 2005 manuscript) [hereinafter, White, *A General Model*].

³ Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 Harv. L. Rev. 1393 (1985).

consumers, and finally to the adoption of bankruptcy systems that offer an increasingly more accessible discharge.⁴ Viewing the relaxation of consumer credit regulations as an aspect of globalization, the comparative literature resonates with the political economy literature about globalization. Writers in that vein consistently have argued that globalizing economies must provide some form of relief (here, the bankruptcy discharge) for those that bear the adverse effects of the unforgiving competitive markets that globalization induces (here, those who borrow to the point of financial distress).⁵ Indeed, the United States appears to be unique in responding to rising levels of credit-induced financial distress with a harshening of the bankruptcy process.⁶

In truth, however, the link is considerably more complex than existing analyses suggest. For example, to take a complexity that is a prominent theme in this essay, data and policy about consumer credit blend two markets with distinct macroeconomic

⁴ Jason Kilborn, *The Innovative German Approach to Consumer Debt Relief: Revolutionary Changes in German Law, and Surprising Lessons for the United States*, 24 Nw. J. Int'l L. & Bus. 257 (2004) [hereinafter Kilborn, *German Approach*]; Jason Kilborn, *Continuity, Change, and Innovation in Emerging Consumer Bankruptcy Systems: Belgium and Luxembourg* (unpublished 2005 manuscript) [hereinafter Kilborn, *Belgium and Luxembourg*]; Jason Kilborn, *La Responsabilisation de l'Economie: What the U.S. Can Learn from the New French Law on Consumer Overindebtedness*, 26 Mich. J. Int'l L. 619 (2005) [hereinafter Kilborn, *New French Law*]; Johanna Niemi-Kiesiläinen, *Changing Directions in Consumer Bankruptcy Law and Practice in Europe and USA*, 20 J. Consumer Pol'y 133 (1997); Jay Westbrook, *Local Legal Culture and the Fear of Abuse*, 6 American Bankr. Inst. L. Rev. 25 (1998); Teresa Sullivan, Elizabeth Warren & Jay Westbrook, *The Fragile Middle Class* (2000).

⁵ Raghuram G. Rajan & Luigi Zingales, *Saving Capitalism from the Capitalists* (2003) (asserting that thesis). Mark Roe has made the most detailed explication of this point in the legal context. Mark J. Roe, *Backlash*, 98 Colum. L. Rev. 217 (1998); Mark J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (2003).

⁶ The most telling example is the recent Enterprise Act of 2002, which recently lowered the discharge period in the UK from three years to one year. Insolvency Act 1986 § 279 (as amended by Enterprise Act 2002 § 256). I should not make too much of this point, because in many respects the American system still could be viewed as one of the most, if not the most, lenient. From that perspective, some (though certainly not I) might argue that the comparative trends reflect convergence on an ideal system.

implications and justifications. On the one hand, a dominating motivation for opening consumer credit markets often is the hope that an increase in consumer credit will jump-start spending and thus lead to overall growth of the economy.⁷ At the same time, concerns about entrepreneurialism and the importance of fostering innovation have focused on providing a credible promise of a discharge to failed entrepreneurs.⁸ Previous academic analyses of credit policy have not focused on the difficulties of untangling the separate effects of entrepreneurial and consumer lending on credit and bankruptcy policy.

II. CAUSATION, CONSUMER CREDIT, AND BANKRUPTCY

It is easier to understand that there is a link between consumer credit and bankruptcy than it is to understand what that link is. To say anything informative about

⁷ The most noted example is South Korea. See Ronald J. Mann, *Global Credit Card Use and Debt: Policy Issues and Regulatory Responses* (unpublished April 2005 manuscript) [hereinafter Mann, *Global Cards Policy*]. However, the policy intuition is widely followed. For example, in the United States, consumer spending represents about 70% of the GDP. U.S. Department of Commerce, Bureau of Economic Analysis, Gross Domestic Product First Quarter 2005, available at <http://www.bea.doc.gov/bea/newsrelarchive/2005/gdp105a.pdf>. Thus, substantial increases in consumer spending thus should directly cause an increase in GDP. The basic premise of current Federal Reserve policymaking is that reductions of interest rates will lead directly to increased consumer spending, and thus an increase in GDP. The academic literature strongly supports the idea that loosening of credit constraints can increase personal consumption, but is much more ambiguous on the relation between personal consumption and real economic growth. E.g., Philippe Bacchette & Stefan Gerlach, *Consumption and Credit Constraints: International Evidence*, 40 J. Monetary Econ. 207 (1997); Sydney Ludvigson, *Consumption and Credit: A Model of Time-Varying Liquidity Constraints*, 81 Rev. Econ. Stat. 434 (1999).

⁸ Bruce Mann's historical work shows that this impulse has a lengthy pedigree in this country. Bruce H. Mann, *Republic of Debtors: Bankruptcy in the Age of American Independence* (2002). John Armour's recent empirical work suggests that the rigor of the discharge has a substantial effect on entrepreneurial activity. John Armour, *Personal Insolvency Law and the Demand for Venture Capital*, 5 Eur. Bus. Org'n L. Rev. 87 (2004) John Armour & Douglas J. Cumming, *Bankruptcy Law and Entrepreneurship* (unpublished 2005 manuscript), available at www.bepress.com. For more general theoretical discussions of the relation between bankruptcy policy and productivity, see Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 Am. Bankr. L.J. 81 (2002); Nicholas L. Georgakopoulos, *Bankruptcy Law for Productivity*, 37 Wake Forest L. Rev. 51 (2002); Richard Hynes, *Overoptimism and Overborrowing*, 2004 BYU L. Rev. 127; Richard Hynes, *Non-Procrustean Bankruptcy*, 2004 Ill. L. Rev. 301.

the policy implications of the interaction, it is necessary to develop some factual premises about how one affects the other. Thus, it requires some factual understanding of the causative effects that run from credit to bankruptcy and from bankruptcy to credit.

A. From Borrowing to Bankruptcy

At first glance, it seems odd to ask whether borrowing causes bankruptcy. Of course it does. How easy is it to become bankrupt without debt? The point here, however, is to understand what that relation is. The fundamental problem with the existing literature is that it ignores the unusual trifurcated structure of credit card transactions (with separate points of agreement, purchase and borrowing). My related research suggests that those transactions generate externalities.⁹ In particular, that work shows a substantial link between consumer credit behavior and bankruptcy, starting from market imperfections and behavioral biases that cause consumers to borrow imprudently, and leading to excessive levels of financial distress.

Starting with the structure of the transaction, the separation of three points in the credit card lending transaction obscures the borrower's ability to assess the relative risks and returns of the transaction. The first is the time of the account opening – when the contract that will govern the borrowing is made. This point has little significance to the overall transaction, because the borrower has not made a decision to use the card.¹⁰ The

⁹ Ronald J. Mann, *Credit Cards, Consumer Credit, and Bankruptcy* (unpublished March 2005 manuscript) [hereinafter Mann, *Cards Data*].

¹⁰ The problem is exacerbated by the dynamics of credit card contracting. Thus, even if it were rational for a borrower to study the contract (which it typically is not), and even if the borrower evaluated the contract with perfect rationality (which also would be atypical), it would be difficult for the borrower to price the particular contracting and repayment terms, given the likelihood that the lender would reserve the right to change those terms at any time and apply the changed terms to outstanding borrowings.

second point is the time of the purchase – when the decision to spend is made. The third point is the time of the monthly bill – when the decision to borrow is made. In that model, the crucial decision point is deferred at least to the point of purchase. Because of those problems, it is difficult to countenance the assumption of contracting decisions that rationally assess the risks and rewards of a particular borrowing transaction – the general foundation of the economic literature on consumer credit. That assumption does not map in any plausible way to the transactional structure of the dominant retail payment system in the American economy.

The empirical evidence is telling. Among other things, the available evidence indicates that increases in consumer credit correlate with increases in consumer bankruptcy. More pointedly, the evidence indicates that credit card debt correlates with subsequent increases in consumer bankruptcy, *even when overall borrowing is held constant*. Therefore, in a country in which the level of overall consumer borrowing remains constant, the evidence indicates that an increase of about \$100 per capita in annual credit card debt is associated with an increase in bankruptcy filings two years later of about 200/million.¹¹

The problem would raise relatively little social concern if borrowers and lenders were the only ones affected by excessive borrowing. It might reflect a value transfer from consumer borrowers to lenders, or a diversion of consumer resources toward the

¹¹ Mann, *Cards Data*, *supra* note 9. To be sure, we cannot be certain in the abstract that an increase in distress is suboptimal. Surely even a well-ordered economy, with an optimal level of risk-taking, would include *some* amount of financial distress. It is thus empirically debatable whether any particular economy has excessive levels of distress. For purposes of this paper, however, I generally accept the implicit view of the existing literature that the level of financial distress in the United States economy currently is excessive.

repayment of loans and away from investment or spending. Indirect effects such as those, however, would not motivate broad policy responses. In fact, however, consumer credit contracts generate substantial externalities, at least when they lead to financial distress. There are the costs of unpaid loans to other creditors – costs that are particularly serious as a policy matter when they are borne by nonadjusting creditors that have not priced into their dealings the likelihood that the bankrupt consumer will fail to repay.¹² There are the losses to the economy of the diminished productivity of those in financial distress, a problem that is exacerbated if financial distress is likely to lead to such problems as a decline in mental and physical health.¹³ There are the costs to others in the family of the distressed borrower; children and spouses suffer substantially in the event of financial distress of a wage-earning spouse.¹⁴ Collectively, those costs suggest a substantial external cost of consumer financial distress. Coupled with the evidence of a direct causative link between borrowing and bankruptcy, there is good reason to attend to that link when designing optimal regulatory policies for consumer credit markets and bankruptcy systems.

B. From Bankruptcy to Borrowing

The converse question is the extent to which the existence of the bankruptcy system influences borrowing in the economy. On that point, for example, the dominant

¹² We know little about the prevalence of nonadjusting creditors in consumer bankruptcy cases. For evidence from business cases, see Elizabeth Warren & Jay L. Westbrook, *Contracting out of Bankruptcy: An Empirical Intervention*, 118 Harv. L. Rev. 1197 (2005).

¹³ Melissa Jacoby argues that it does. Melissa B. Jacoby, *Does Indebtedness Influence Health? A Preliminary Inquiry*, 30 J.L. Med. & Ethics 560 (2002).

¹⁴ Elizabeth Warren and Amelia Warren Tyagi, *The Two-Income Trap: Why Middle-Class Mothers and Fathers Are Broke* (2003); Christopher L. Peterson, *Taming the Sharks: Towards a Cure for the High Cost Credit Market* (2004).

models of consumer credit markets show how in a world populated by omniscient and wholly rational actors a loosening of bankruptcy standards – to make bankruptcy less rigorous or more readily available – would lead to an increased demand for borrowing. The central concern of those models is how to resolve the problem of moral hazard. Thus, they reason, rules that permit borrowers to display their repayment proclivities by accepting such remedies as arm-breaking are important to allow signaling to prevent markets from unraveling as more and more borrowers succumb to the moral hazard.¹⁵ More pointedly for policy purposes, many writers in the populist vein emphasize the possibility that a loosening of the rigors of bankruptcy might lead to opportunistic borrowing. Thus, those writers contend that consumers often borrow *because* they know that bankruptcy will forgive their obligation to repay the loan.¹⁶

What we know about the reality of bankruptcy makes it difficult to credit that link as a sufficiently important pattern of real-world behavior to give it an important role in shaping policy. First, the existing literature includes a rich series of research projects designed to collect evidence about the nature of the people that file for consumer bankruptcy in this country. Although that literature is nuanced and does not always provide robust conclusions,¹⁷ it does plainly suggest that the overwhelming majority of

¹⁵ Adler, Polak and Schwartz, *supra* note 1; Samuel A. Rea, Jr., *Arm-Breaking, Consumer Credit and Personal Bankruptcy*, 22 *Econ. Inquiry* 188 (1984).

¹⁶ *E.g.*, Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 *BYU L. Rev.* 177; Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis* *Nw. U. L. Rev.* (forthcoming 2005); Todd J. Zywicki, Testimony Presented to the Judiciary Committee of the United States on Bankruptcy Reform (Feb. 10, 2005) [hereinafter, Zywicki, *Testimony*].

¹⁷ It is not clear, for example, whether older people suffer more or less in bankruptcy than younger people.

people that file for consumer bankruptcy in this country are in deep financial distress.¹⁸ Thus, that evidence suggests that the abusive and highly compensated filer seeking to discharge luxurious consumer spending is largely a myth.¹⁹ Surely, there are abusive cases, but there is little reason to think that those cases are sufficiently frequent to undermine the need for a broad discharge.

We also now have empirical evidence from a comparative study of consumer credit, credit card debt, and consumer bankruptcy in about two-thirds of the world credit-card market.²⁰ If the opportunistic story were correct, we would see a steep rise in credit card debt shortly before bankruptcy – in the six months immediately preceding the bankruptcy. Thus, as bankruptcy grew closer, the causal connection between increases in credit card borrowing would grow more significant and display a substantially higher coefficient. As it happens, however, the evidence is contrary to that understanding. Rather, the evidence suggests that the relation between increases in borrowing and consumer bankruptcy plays out over a long period – suggesting a slow pattern of consumers borrowing ever farther beyond their means so that their financial position is so

¹⁸ Teresa Sullivan, Elizabeth Warren & Jay Westbrook, *As We Forgive Our Debtors* (1989); Sullivan, Warren & Westbrook, *supra* note 4; David U. Himmelstein, Elizabeth Warren, Deborah Thorne & Steffie Woolhandler, *MarketWatch: Illness and Injury as Contributors to Bankruptcy*, Health Affairs, February 2005; Katherine Porter and Deborah Thorne, *Going Broke and Staying Broke: The Realities of the Fresh Start in Chapter 7 Bankruptcies* (unpublished 2005 manuscript).

¹⁹ Lynn LoPucki provides a contrary account based on his experiences as a lawyer in consumer bankruptcy cases. See *Common Sense Consumer Bankruptcy*, 71 Am. Bankr. L.J. 461 (1997). The experiences he recounts, however, are difficult to reconcile with the empirical evidence with which I am familiar. There is some possibility that the reality of the system has changed since his experiences in practice, which admittedly did not extend into the period traced by the recent empirical evidence that Sullivan, Warren & Westbrook emphasize.

²⁰ Mann, *Cards Data*, *supra* note 9.

fragile that they are unable to withstand the typical misfortunes that are so common in our globalized economy.²¹

To me, the most intriguing aspect of the empirical evidence is the evidence suggesting a distinct pattern for entrepreneurial borrowing. To the extent there is any relevant data, the data suggest that a robust bankruptcy discharge is associated with a valuable increase in entrepreneurial risk-taking, which is likely to create positive spillover effects. Thus, for example, Rafael Efrat has argued as a comparative matter that countries without strong safety nets that wish to support entrepreneurial innovation are driven to provide lenient discharges. More recently, John Armour has provided a fascinating empirical test, which suggests that the leniency of the bankruptcy discharge can be associated with measures of the level of entrepreneurial risk-taking – venture-capital investment activity and self-employment, in particular.²² Similarly, Michelle White recently has presented data suggesting that increases in property exemption levels help to foster small-business formation by providing a form of implicit wealth insurance.²³ In a related paper, using plausible values for the level of opportunistic activity in existing debt markets, her models indicate that the optimal bankruptcy system would have a substantial and nonwaivable postbankruptcy income exemption – something much like Chapter 7 of the existing Bankruptcy Code.²⁴

²¹ Mann, *Cards Data*, *supra* note 9.

²² See Armour, *supra* note 8; Armour & Cumming, *supra* note 8.

²³ See Wei Fan & Michelle J. White, *Personal Bankruptcy and the Level of Entrepreneurial Activity*, 46 J.L. & Econ. 543 (2003).

²⁴ See White, *Bankruptcy and Consumer Credit*, *supra* note 2.

There is a distinct but related question about the relation between bankruptcy policy and bankruptcy rates. Although we would expect that a bankruptcy system that provides more relief would lead to more filings than one that provides less relief, we know little empirically about the fine details of that point. For example, although the Japanese are thought by some to be the most culturally averse to bankruptcy,²⁵ the Japanese bankruptcy filing rates are now higher than those in Australia and about the same as those in Canada, apparently in response to the recently adopted Westernized consumer bankruptcy system. The extent to which the higher filings rest on the new system, as opposed to cultural or institutional factors is an important one, but one that could not be resolved without detailed statistical analysis that has not yet been undertaken in any country.

For example, evidence from Canada tends to suggest that debt levels have been much more important in the level of filings than anything else. Diane Ellis points out that bankruptcy filings in Canada rose quite rapidly after Visa entered the market; she pointedly compares that fact to the similar rise in filings here shortly after the deregulation of credit card interest rates. Her point is that the increased filing rates in this country are more likely attributable to higher credit card debt than to the major changes in US bankruptcy law at about the same time.²⁶

²⁵ See Nathalie Martin, *The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation*, 28 Boston College Int'l & Comp. L. Rev. 1 (2005)),

²⁶ Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-offs, and the Personal Bankruptcy Rate*, Bank Trends 98-05 (FDIC, Div. of Ins., Mar. 1998). I discount the argument of Buckley, *supra* note 30, because his comparative econometric analysis of the causes of USA and Canadian bankruptcy filings includes no data on debt levels in the two countries.

One of the hardest problems is that it is hard to define “leniency” in this context. Thus, people commonly characterize the American consumer bankruptcy system as the most lenient, based on the immediate discharge that it offers. But when we add means testing, broaden the categories of debts that are not dischargeable, and increase the period between permitted filings (as in the United States), it becomes less clear that the practical effect of the system is more hospitable than a simpler system that grants a free and complete discharge to all after a short waiting period. It is even harder to assess the effect of the provisions that create administrative hurdles to filing (credit counseling, increased documentation, and lawyer certifications), which might limit filings by depriving potential filers of qualified advisers. Thus, we should be cautious in assuming that we can predict the effects of any particular bankruptcy reform on filing rates.

* * * * *

In sum, the existing evidence strongly suggests that increases in consumer credit impose substantial subsequent externalities on society, and casts doubt on the gravity of the concern that lax bankruptcy policy will lead to opportunistic borrowing and a subsequent unraveling or deterioration of the consumer credit markets. If anything, the data suggest, particularly with respect to entrepreneurial borrowing, that a loosened discharge could have positive spillover effects by increasing the demand for activity most likely to have positive external effects.

C. A Note on Stigma

Views on the relation between the bankruptcy discharge and consumer economic activity are closely related to the problem of stigma, which has dominated academic and political debates about bankruptcy in this country and elsewhere. The critics of the status

quo claim that rising bankruptcy rates reflect a decline in moral fiber, evidenced by an undue readiness to accept relief in bankruptcy. Thus, the argument goes, there is a direct causal link between the improved public perception of bankrupts in the last few decades and the large-scale increase in the number of people who file for bankruptcy.

It is unfortunate that this point is treated as a serious subject for policy debate. First, as noted above, the empirical data that we have on this question points in one direction. Most filers in this country are in situations of such extreme distress that it is not plausible to view bankruptcy as a planning tool for them. Indeed, it is unlikely that any particular feature of the legal system (beyond the availability of an automatic stay) would have a notable effect on their decision to file. In other words, it is as likely as not that those individuals would file even under a much more onerous system. Efforts to make the system less accessible only increase the costs to those filers and to the taxpayers that fund the system.

Related to that point is the reality that only a small portion of the individuals who efficiently could file choose to do so.²⁷ Because it is quite difficult to collect datasets of people that have not filed for bankruptcy that are in financial circumstances comparable to those that do file, we know little or nothing about precisely what motivates the particular individuals that file to do so. Without that knowledge, it is difficult to credit the simplistic notion that lack of stigma generally is what is motivating them. If the

²⁷ See Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at Incentives Under U.S. Bankruptcy Laws and a Proposal for Change*, 65 U. Chi. L. Rev. 685 (1998) [hereinafter White, *Why It Pays*]; Michelle J. White, *Why Don't More Households File for Bankruptcy?*, 14 J.L. Econ. & Org'n 205 (1998) [hereinafter White, *Why Don't More Households File?*].

decline in stigma is a general societal problem, why doesn't stigma motivate the millions of other similarly situated nonfilers?

Third, the studies that have suggested that a decline in "stigma" has accounted for much of the filing surge since the enactment of the 1978 legislation are methodologically unsound. The general technique of the existing studies is to proceed by the circuitous route of identifying various other institutional reasons for filing changes, treating "stigma" as the cause of all remaining unexplained variation in filing rates.²⁸ Others use crude proxies for strength of social norms (measured, for example, by urban residency, Catholicism, and age).²⁹

But that methodology even on its own terms cannot possibly identify any share of filings attributable to a decline in the sense of the filers that their conduct is shameful, because that methodology cannot disentangle that effect from other closely related effects. For one thing, the studies could do a much better job of identifying more specific debt and credit-card related variables. In my related paper, a relatively simple model with variables for changes in GDP, credit card debt, credit card spending, and consumer credit can explain about 90% of the variation in bankruptcy filing rates in a dataset of six

²⁸ E.g., David B. Gross & Nicholas S. Souleles, *An Empirical Analysis of Personal Bankruptcy and Delinquency*, 15 Rev. Fin. Stud. 319 (2002).

²⁹ See F.H. Buckley & Margaret F. Brinig, *The Bankruptcy Puzzle*, 27 J. Legal Stud. 187 (1998). The argument is that correlations between lower bankruptcy filings and greater population shares of urban residents, Catholics, and the elderly indicate that bankruptcy filings are a sign of the breakdown of social networks.

different countries. None of the “stigma” literature has included detailed variables to assess the relation between credit card use and bankruptcy filings.³⁰

More broadly, it is difficult to see how any such study, however carefully designed, could separate the effect of “stigma” from a “learning-curve” effect associated with increased awareness of the bankruptcy process. It is plain that consumer bankruptcy filings increase with increases in consumer debt. As filings increase, the average person might be more aware of the bankruptcy process and view it more charitably. Some of the changing view might simply be attributable to an accurate understanding of the process. Yet at the same time, increased awareness might cause some to fear bankruptcy filing even more than they did before. More importantly, it is quite difficult to connect the effects of that increased awareness with actual filing patterns. The increased awareness is likely to affect a large number of people, of whom only a small number choose to file.

Finally, most fundamentally, the acceptance of a stigma lever as a policy tool has unpleasant consequences, which seem perverse in light of the sociological literature and commonsense understandings of the negative effects of stigma. If we credit the possibility that even a substantial number of the current bankruptcy filers are forced into filing by exogenous circumstances that few could surmount, exactly what are we trying to accomplish by increasing the sense of shame and blameworthiness we wish them to attach to their actions? Would we deal with the fallout of one-parent households by increasing the stigma of divorce? As Mark West shows in his discussion of Japanese

³⁰ See Mann, *Cards Data*, *supra* note 9. Compare Buckley & Brinig, *supra* note 29 (expressing doubt that lending variables could explain the variation and noting that they did not use lending data in their models); F.H. Buckley, *The American Fresh Start*, 4 S. Cal. Interdis. L.J.

who use suicide to avoid the shame of financial insolvency, there are ways of responding to financial distress that have greater social cost than a bankruptcy filing.³¹

III. REGULATING CONSUMER CREDIT

With that empirical perspective in hand, I turn now to a concrete discussion of the relevant regulatory problems. When we think about the regulation of consumer credit markets, we must start with the reality that the majority of credit transactions are value-increasing transactions for all parties that engage in them. Notwithstanding the relation between an increase in borrowing and an increase in financial distress, it remains true that the overwhelming majority of borrowers successfully repay their debts. Lenders in free markets presumably profit from almost all of those transactions, and borrowers presumably profit from many of them – they would profit from all of them if it were not for the likelihood that some borrowing transactions will reflect poor judgment even if the borrower ultimately obtains the funds to repay the loan.

Moreover, many of those transactions will be valuable not only for the parties that participate in them. They will generate *positive* externalities, as the expenditures will indirectly support the manufacturing and service sectors of the economy. Thus, as a substantial body of literature suggests, there is in many circumstances a positive relation between increases in household indebtedness at one point in time and consumer

67 (1994) (econometric model designed to test differences between Canadian and American filing rates that does not include any data related to debt in the two countries).

³¹ Mark D. West, *Dying to Get out of Debt: Consumer Insolvency Law and Suicide in Japan* (unpublished 2003 manuscript).

expenditures and gross domestic product some years later.³² The goal, then, is to identify policies that can isolate the transactions most likely to impose costs on the rest of society and burden those transactions without imposing clogging hurdles on the value-increasing transactions that reflect the bulk of consumer expenditure and borrowing.

It is likely that some of the instrument-induced risk could be managed through reforms that shift payment transactions away from credit cards (which have such a strong connection to financial distress) to other electronic payment systems such as debit cards.³³ It might seem odd to think that a shift from credit cards to debit cards would have a substantial effect on prodigal expenditure and borrowing, but the existing data strongly suggests that it does. The correlations between increased credit card use and increases in consumer credit, for example, largely dissipate if overall plastic-card use is substituted as the explanatory variable.³⁴ When we recall the reasons for rising debit card use in the United States – the most plausible explanation being a quasi-rational precommitment to enforced budgeting³⁵ – that data is easier to understand.

³² *E.g.*, Dean M. Maki, *The Growth of Consumer Credit and the Household Debt Service Burden*, in *THE IMPACT OF PUBLIC POLICY ON CONSUMER CREDIT* (Thomas A. Durkin & Michael E. Staten eds. 2002).

³³ *See* Mann, *Global Cards Policy*, *supra* note 7. In that paper I recommend, among other things, prohibitions on reward programs that offer “cash-back” for credit-card purchases, rules that ban marketing of credit cards to minors and college students, and so-called “universal default” contract provisions. I also recommend shifting the existing disclosure system (focused on the time of contracting) to one more focused on the time of purchase and repayment.

³⁴ Mann, *Cards Data*, *supra* note 9.

³⁵ Mann, *Cards Data*, *supra* note 9; Mann, *Global Cards Policy*, *supra* note 7.

Still, what we see from the UK – where credit card use as a share of plastic card use has remained small³⁶ – is that a fully developed economy still can develop a consumer debt load of troubling proportions.³⁷ Indeed, the UK is not alone. Many of the countries with the most serious problems with burgeoning consumer credit are not countries in which the credit card has yet taken hold.³⁸ Thus, although payment systems reform might do a great deal, especially in countries in which credit cards are dominant, further steps to control the externalities of excessive borrowing are likely in most cases to be appropriate.

A. Usury Regulations

Although it should come as a surprise to those not familiar with the literature, the most common response to the problem has been to recommend a formal price regulation: a so-called “usury” statute that would bar transactions above specific prices.³⁹ So, for example, recent years have seen one version or another of that approach from academics

³⁶ Mann, *Global Cards Policy*, *supra* note 7.

³⁷ In the UK, a disproportionately large amount of the debt is in the form of home mortgages. For general discussion of the problem, see The Griffiths Commission on Personal Debt, *What Price Credit?* (2005) [hereinafter Griffiths Commission, *2005 Report*].

³⁸ Mann, *Global Cards Policy*, *supra* note 7; Kilborn, *German Approach*, *supra* note 4; Kilborn, *New French Law*, *supra* note 4; Kilborn, *Belgium and Luxembourg*, *supra* note 4; *see also European Card Review*, *European Payment Cards Yearbook 2005* § 3.2 (explaining that credit card use in the EU is concentrated in the UK, Ireland, and Turkey, while consumer credit has risen broadly throughout).

³⁹ There are numerous other possible approaches. The proposed EU Directive, for example, includes a variety of regulatory approaches that have not yet been tried here, the most important being requirements that lenders give advice about appropriate products; responsible lending obligations; and prohibitions on unfair terms being the most important.

of such widely varying perspectives as Elizabeth Warren, Eric Posner, and Christopher Peterson.⁴⁰

As a structural matter, those proposals confront two foundational difficulties. The first is the acknowledged bluntness of usury as a tool to respond to social problems.⁴¹ The different proponents of usury proposals have different concerns. Posner is concerned about the externalities that risky credit transactions impose through increasing the cost of the welfare system. Warren is concerned about the likelihood that the lending often reflects poor judgment on the part of those that engage in it. As discussed above, I am more concerned about the externalities financial distress creates. In any case, however, the concern is not simply that the rate is high. The concern is that high interest rates are a useful proxy for the types of transactions that justify social concern, whatever the specific basis for that concern.

Thus, any usury limitation necessarily will be both over- and under-inclusive. Indeed, Posner recognizes this problem specifically. His model recognizes that the limitation he proposes would forbid some transactions that in fact are value-increasing – risky but not prodigal transactions for which a high rate of interest is appropriate – and permit some transactions that impose externalities – prodigal borrowing that occurs at rates below the usury cap. Because borrowers and the uses that they make of funds are so heterogeneous, the bluntness of the tool is a serious problem. If even an omniscient

⁴⁰ Warren & Tyagi, *supra* note 14; Eric Posner, *Contract Law in the Welfare State: A Defense of Usury Laws, the Unconscionability Doctrine, and Related Limitations on the Freedom to Contract*, 24 J. Legal Stud. 283 (1995); Peterson, *supra* note 14.

⁴¹ James J. White, *The Usury Trompe L'Oeil*, 51 S.C. L. REV. 445 (2000) (making this point in some detail).

regulator could not easily define a usury limit that would produce optimal benefits, we should be reluctant to expect that the conflicting interests that will motivate legislative action will lead to anything that approximates a plausible level.

The bluntness problem is aggravated by the rapid segmentation of the consumer borrowing market. Even fifteen years ago, most credit card issuers charged most borrowers in their portfolio one of a small number of rates, with very few distinctions based on the relative creditworthiness of different customers in the portfolio. The lesson of the last ten years, however, has been that information technology has made it much easier to loan larger amounts of money more reliably to individuals with less extensive and less positive credit histories. This has resulted in an increasingly sophisticated differentiation among borrowers, in which borrowers of different risks pay cognizably different rates of interest, the kind of segmentation that is highly to be praised in an assessment of the market.⁴² Indeed, it is relatively plain that this has led to a decline in the effective interest rate charged on outstanding credit card debt.⁴³

To be sure, the rate of default on high-interest loans is likely to be higher than the rate of defaults on a set of loans to persons of uniformly higher creditworthiness. Yet that says little about whether the transactions are so risky as to justify prohibiting them. What remains plain is that a usury regulation is not well designed to sort the undesirable transactions from the desirable ones that increase social wealth.

⁴² Mark Furletti, *Credit Card Pricing Developments and Their Disclosure* (Fed. Res. Bank of Philadelphia, Payment Cards Center, Discussion Paper) (January 2003). For similar analysis of events in the UK and France, see Department of Trade and Industry, *The Effect of Interest Rate Controls in Other Countries* (2004) [hereinafter DTI Report].

⁴³ See Figure Two.

Another major problem that any usury regulation must confront is the distortion it will impose on the credit market. The discussion above explains why a usury regulation will impose costs even if borrowers and lenders take no actions to avoid the application of the regulation. In fact, however, a usury regulation is likely to lead not only to the suppression of some transactions that impose externalities (the positive aspect of a usury law), but to the shifting of a substantial portion of the outlawed transactions either to markets that are beyond the scope of the regulation or to extralegal markets beyond the scope of any regulation. For one thing, what little evidence we have suggests that the demand for credit is remarkably stable even across national, cultural, and regulatory boundaries.⁴⁴ Therefore, low-income people have similar needs for credit everywhere, and regulatory constraints will not change that.⁴⁵ Because in practice usury regulations apply differentially and haphazardly to the highly segmented menu of consumer credit products, the potential for shifting among products – which might at first glance seem a trivial detail – is in fact a serious problem.⁴⁶

The evidence for this problem is surprisingly varied. In Japan, for example, restrictions that have prevented banks from issuing revolving credit have led to a marginal decline in the amount of credit, because the lenders to which the market shifts are not as well-situated to do this lending as banks (primarily, I believe, because of the

⁴⁴ See Mann, *Global Cards Policy*, *supra* note 7 (discussing relatively uniform levels of consumer credit in developed countries).

⁴⁵ DTI Report, *supra* note 42.

⁴⁶ See White, *supra* note 41.

information banks have about their depository customers).⁴⁷ Nevertheless, it is also fair to think that those regulations have led to a much larger shift in lending to relatively unregulated non-bank consumer lenders (the *sarakin* and *yenya* of Japanese news media). Thus, the most notable effect of the prohibition has been to shift borrowers from the most heavily regulated and responsible lenders to the least regulated and responsible.⁴⁸ To be sure, if one believed that existing insolvency procedures are systematically too lenient, then a system that permitted people to opt into harsher procedures that involved corporal abuse or imprisonment could be optimal.⁴⁹ Although I am convinced of the value of harsh sanctions in the commercial context,⁵⁰ I am willing to assume that in all of the important commercial nations (even the United States), the rigors of consumer bankruptcy as it currently exists are sufficient to make recourse to extralegal enforcement mechanisms suboptimal.

Similarly, American historians suggest that one of the main reasons regulators pushed for banks to enter the consumer credit market in the 1920's was to shift consumer lending from smaller and less reputable lenders to banks, which were thought to be

⁴⁷ See Ronald J. Mann, *Credit Cards and Debit Cards in the United States and Japan*, 55 Vand. L. Rev. 1055 (2002).

⁴⁸ See Ronald J. Mann, *Regulating Internet Payment Intermediaries*, 82 Texas L. Rev. 681 (2004) (discussing benefits of keeping consumer transactions in the hands of banks rather than smaller and less reputationally constrained entities).

⁴⁹ For the classic model of the demand for extralegal enforcement of consumer credit contracts, see Rea, *supra* note 15. In his model, the basic problem is moral hazard. Borrowers agree to harsh consequences to reveal their intention to repay.

⁵⁰ See Ronald J. Mann, *Information Technology and Non-Legal Sanctions in Financing Transactions*, 54 Vand. L. Rev. 1627 (2001); Ronald J. Mann, *Verification Institutions in Financing Transactions*, 87 Georgetown L.J. 2225 (1999).

kinder, gentler, and more reliable conduits for this activity.⁵¹ More recently, empirical evidence about market shifts at the time of credit card rate deregulation in the United States in the early 1980's shows significantly different rates of shifts from finance companies to credit card lenders based on the nature of rate regulation.⁵² Finally, the history of consumer mortgage lending in both Canada and the UK shows a massive shift of the market to – and from – banks based on regulations that permit – or prohibit – banks from issuing consumer mortgages at market rates.⁵³

One possible response would be to solve the problem of shifting by adopting a much broader usury regulation. In Japan, for example, if regulators wished to restrict credit entirely rather than simply allocate the profitable lending to finance companies, they could simply apply usury limits without exceptions, so that all kinds of lending transactions would be covered. It is not clear, of course, what effect that would have on lending that depends explicitly on extralegal methods of enforcement, a market that experience suggests will be significant wherever usury laws are relied on heavily.

More practically, the heterogeneity of consumer credit products and markets makes it likely that any broad-brush response would run headlong into the bluntness problem discussed above. For example, market interest rates on payday loans in the United States commonly are in the range of 500%.⁵⁴ We might accept the fact that a risk

⁵¹ Harold van B. Cleveland, *CitiBank: 1812-1970* (1986); James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* (1992).

⁵² Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 *Yale J. on Regulation* 201 (1986).

⁵³ See Ackrill & Hannah, *supra* note 39; Duncan McDowall, *Quick to the Frontier: Canada's Royal Bank* (1993).

⁵⁴ See Peterson, *supra* note 14.

premium would justify doubling or tripling the rate that a creditworthy borrower would pay, but rates like these – dozens of multiples of market rates – at first glance suggest a wholly abusive market. The difficulty, however, is that an obvious reason for those rates is the relatively small size of the transactions in question. If we suppose that there are fixed costs in administering any lending transaction,⁵⁵ then as the size of the transaction approaches zero, the rate that would cover the cost of funds, risk of loss, and transaction costs would become asymptotically high.

I do not intend to suggest that the markets for payday lending are well functioning or that the rates are low. I do think, however, that the rise of national publicly traded payday lenders suggests that the market is becoming much more competitive, at least in those jurisdictions that have usury ceilings sufficiently high to permit those firms to operate profitably.⁵⁶ What little comparative evidence we have (government reports issued in the UK in the last few years) suggests that consumers respond quite rationally to the differences in major lending products available to them.⁵⁷ Predictably enough, the evidence shows that consumers perceive there to be a spectrum from relatively disadvantageous products (like rent-to-own suppliers and pawnbrokers) to *relatively* benevolent products like payday loans. A comparative study of current markets suggests, as you might expect, that consumers use the relatively disadvantageous products only in

⁵⁵ DeMuth, *supra* note 52, at 228, reports a Federal Reserve study indicating that about 60% of the costs of consumer lending are administrative costs unrelated to the cost of funds. For a detailed discussion of this problem in the UK, see Griffiths Commission, *2005 Report*, *supra* note 37.

⁵⁶ See Robert Elder, *Payday Lenders Banking on New State Law*, Austin American Statesman, Apr. 22, 2005.

⁵⁷ DTI Report, *supra* note 42; Griffiths Commission, *2005 Report*, *supra* note 37.

areas in which regulatory authorities have foreclosed opportunities for the relatively benevolent ones.⁵⁸ Thus, we might think, for example, that rules that relaxed restrictions sufficiently to permit a competitive market for payday lenders ultimately would benefit consumers by giving them a sufficient supply in that market to forestall their use of more onerous rent-to-own products.

The point of this discussion is to suggest that regulators will need to have a sophisticated sense of the on-the-ground value and cost structure of the various products that they are regulating to design usury regulations that will not be counter-productive. The difficulty of that problem convinces me that the blunt implications of any sensible set of ceilings will be serious.

* * * * *

Thus, given the difficulties of separating value-increasing transactions from value-diminishing transactions, I am skeptical about the value of usury regulations as a general policy tool.⁵⁹ This is not to say that a high ceiling might not be appropriate. Such a ceiling would have the salutary effect of prohibiting transactions at rates sufficiently high to suggest a lack of engaged consent by the borrower. Thus, they might have a targeted effect on various classes of subprime lending markets. They would not, however, provide a substantial response to the overindebtedness problem on which I focus here.

⁵⁸ See DTI Report, *supra* note 42.

⁵⁹ UK policymakers in the last few years have rejected interest rate caps after a series of detailed studies of subprime lending markets convinced most of those involved that caps would do more harm than good. DTI Report, *supra* note 42; Griffiths Commission, *2005 Report, supra* note 37.

B. Minimum Payments

Another approach would be to impose rules that require lenders of certain types to impose a certain minimum payment amount each month. For example, Britain formerly had a rule requiring cardholders to repay 15% of their credit card debt each month.⁶⁰ Even American regulators, acting through the Federal Financial Institutions Examination Council (an interagency group that oversees standards for federal examination of financial institutions), have issued a recent “guidance” suggesting that lenders should not permit negative amortization and should require repayment in a “reasonable” time.⁶¹ Although targeted primarily to the subprime lending market, the annual reports of major American card issuers suggest that the guidance has had an important effect on their lending practices.⁶²

One systematic advantage of that kind of approach is that it does not directly prohibit any value-increasing transaction. Borrowers that believe they have uses of funds that exceed the market interest rates are free to borrow them from lenders that believe the borrowers are sufficiently creditworthy. Of course, that raises the converse question whether there is any reason to think that such proposals would be beneficial. Although I

⁶⁰ Margaret Ackrill & Leslie Hannah, *Barclay's: The Business of Banking 1690-1996* (2001); *The Plastic-Money Would-Be Pre-Election Boom*, *The Economist*, Sept. 9, 1978, at 107 (discussing rule imposed in 1973 and lifted in 1978).

⁶¹ The Federal Reserve press release is at <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030108/>.

⁶² MBNA reports, for example, that it has changed its standard procedure from requiring a repayment of 2.25% (a shade above the interest accruing at 18% each month) to a requirement that each borrower repay 1% of the principal each month in addition to all interest and fees. This is *not* a requirement that each borrower repay its bill in 100 months. As described in the annual report, a borrower that made the minimum payments under that plan, and never made any future

am not convinced the proposals would make a major change, they do seem to me reasonably likely to be beneficial, for two interrelated reasons.

First, and most importantly, there is some likelihood that people in financial distress will not be able to make the payments, and thus will default and fall into bankruptcy sooner rather than later. This would be beneficial if (as knowledgeable writers generally assume), consumer borrowers often defer bankruptcy filings too long.⁶³ The idea is that if we can cause lenders to cut the borrowers off sooner the externalities of financial distress will diminish. In case it is not clear from the discussion above, the reason that we cannot rely on the lender to make the appropriate judgment on that point – the lender, after all, loses in each case in which the borrower does not repay – is that the lender does not bear *all* of the losses of the customer's financial distress. Third parties bear a substantial portion of those losses, giving the lender an inadequate incentive to set payment plans that will minimize the *total* costs of financial distress.

The second effect is less objective, and certainly is related to the first, but focuses more on the nature of the loan that is being extended. When lenders extend closed-end installment loans to fund the purchase of specific commodities, they generally set repayment schedules that mirror the useful life of the subject property. In that model, the lending and purchase go hand in hand in disciplining the borrower's adherence to a budget that matches expenditures (on loan repayments) with the borrower's enjoyment of

purchases, would *never* repay the outstanding debt, because the minimum payment would decline steadily as the outstanding balance declined. See MBNA 2004 Annual Report at 33.

⁶³ See Mann, *Global Cards Policy*, *supra* note 7 (discussing that problem in the context of a ban on universal default rules).

the useful life of the object.⁶⁴ When the loan instead is extended for daily purchases, the enjoyment of which is completed in days or weeks, with repayment deferred for months or decades, we have created a loan that bears no relation to the useful life of the purchases. This is not the place, and I am not the writer, to examine all of the implications of that shift. Yet one relevant implication certainly is the possibility that such loans will have a systematically higher likelihood of default. If that is so, those loans may be more likely to produce external costs than more conventional loans. A natural minimalist response, then, might be to adopt a rule that open-ended lending must have repayment schedules that, *at the outside*, would amortize a loan within 60 months (the long end of the typical range of fully amortizing loans for personal property).

It is difficult to be sure, that such a rule would have important effects. But I would not recommend it if the early evidence did not suggest that even the feeble guidance recently issued by American regulators has had cognizable market effects parallel to the ones that I discuss.⁶⁵ In sum, this reform would not solve the problem. Nevertheless, it certainly appears likely to move things in the right direction.

⁶⁴ This is the point of the “budgetism” that is a prominent theme in Lendol Calder, *Financing the American Dream: A Cultural History of Secured Credit* (1999).

⁶⁵ *See, e.g.*, Bank of America 2004 Annual Report 30, 35, 43, 69 (noting an increase in chargeoffs and provisions for losses on credit card lending because of the change); Citigroup 2004 Annual Report 55 (predicting increased losses and delinquencies because of the change); JPMorgan Chase 2004 Annual Report 21 (predicting that the change will cause increased delinquency and chargeoff rates).

C. Taxing Distressed Debt

The discussion above leads naturally to a more targeted solution: a tax on distressed debt, and in particular a tax on defaulted credit card obligations.⁶⁶ A tax that is imposed on debt that has gone into default is much more carefully tailored to the transactions that are likely to impose externalities than a usury regulation. It will not cover any transaction in which the benefits that the borrower receives from the lending transaction turn out to be adequate to facilitate repayment.⁶⁷ And it responds to the problem more directly than an alteration in minimum payment requirements, because it directly internalizes upon one of the parties to the transaction some of the externalities that the transaction currently shifts to those not party to the transaction.

To the extent that such a tax increases the *ex ante* price of credit in the relative markets, that seems to me an appropriate outcome. Given the rapidly developing segmentation of risk pools, we would expect such a tax to lead to a surcharge of varying sizes based on the anticipated riskiness of the borrower. High quality (high FICO score) borrowers would pay little or no surcharge; low quality (low FICO score) borrowers would pay a much higher surcharge.⁶⁸ From a broader perspective, a surcharge is simply

⁶⁶ This idea is derived from a tax on defaulted credit obligations that is part of the new Belgic bankruptcy system. See Kilborn, *Belgium and Luxembourg*, *supra* note 4.

⁶⁷ Compared to usury regulation, this tax also has the important benefit that it probably could be applied to national banks without risk of preemption or evasion under the National Bank Act, something that is not true for usury regulations. Mark Furletti, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards* (Fed. Res. Bank of Philadelphia, Payment Cards Center, Discussion Paper) (March 2004).

⁶⁸ I use that specific example of segmentation because Furletti's data indicates that segmentation of borrowing pools by FICO scores provides a useful benchmark for the rapidly increasing differentiation of interest rates within a single creditor's portfolio. Furletti, *supra* note 42.

a shift between the parties to the transaction of the costs that the parties presently are jointly externalizing.

To be sure, the tax is likely to cause a contraction of lending to distressed borrowers, as credit card issuers attempt to avoid growth in their portfolio of distressed debt, or an acceleration of the time when those borrowers file for bankruptcy. For reasons discussed above, I also find that possibility appealing, because it is likely to cause borrowers to file for bankruptcy earlier in their downward spiral. The dominant consensus within the body of literature that has examined empirical data about the condition of consumer borrowers by the time they file for bankruptcy is that the existing system generally causes consumer borrowers to file for bankruptcy too late, when an earlier filing might have solved problems with lower total costs.⁶⁹

IV. CONSUMER BANKRUPTCY POLICY

From one perspective, it makes no sense to view consumer bankruptcy policy as a separate topic at all. If the bankruptcy system is part of the social safety net, then we should think about bankruptcy policy alongside health-care policy, insurance policy, entrepreneurial policy, and the like.⁷⁰ Recognizing that there is some truth to that point in an ideal world, it continues to be the case that bankruptcy policy in fact is largely made against the backdrop of its relation to the consumer finance markets. Thus, this part of the essay considers bankruptcy policy in relative isolation, as it relates to the finance

⁶⁹ See *supra* note 63.

⁷⁰ The original source on that point as a matter of theory is Jackson, *supra* note 3. For a broader discussion founded on empirical investigation, see Sullivan, Warren & Westbrook, *supra* note 4.

markets. As the discussion below suggests, my view is that plenty of work remains to be done in upgrading the state of analysis even in that relatively contained milieu. If we could produce a sound understanding of that subject, that should form a basis for considering the extent to which other major policy imperatives (like health care and social security) should influence (or be influenced by) the reality of bankruptcy and financial distress.

A. Bankruptcy Theory

When we come to bankruptcy rules as a policy lever for minimizing the externalities of excessive borrowing, we confront a substantial economics literature about what type of discharge would have the optimal effect on credit markets. The general problem is that bankruptcy law must balance the protection of creditors, which promotes the availability and inexpensive provision of credit, against the protection of debtors, which prevents overindebtedness and underscreening by banks. Thus, strong legal protection of creditors may be efficient *ex ante*, but create inefficiencies *ex post*. For example, Tom Jackson argued two decades ago that basic economic principles called for a relatively unhindered fresh start to prevent the losses society bears when individuals become irretrievably enmeshed in financial distress.⁷¹

Recent literature has focused on various ways in which a less generous bankruptcy system might improve the incentives of consumer borrowers. The Adler, Polak Schwartz (APS) model, for example, suggests that an optimal market would solve moral hazard problems by permitting consumer borrowers to waive their bankruptcy

⁷¹ Jackson, *supra* note 3.

remedies by contract. Similarly, much of Michelle White's research has at least implicitly suggested that exemptions that preserve any substantial asset base for consumer bankrupts will give undue incentives that will cause consumers to file for bankruptcy without adequate financial distress to justify the discharge that they will receive.⁷²

Even on their own terms, that work seems to provide little support for increasing the rigor of the bankruptcy system. Most obviously, the APS model specifically assumes that the parties to a borrowing transaction internalize all costs of financial distress. Essentially, their paper suggests that we should permit contracting out of bankruptcy because in a world where bankruptcy is partly endogenous – within the borrower's control – that contract will allow borrowers to sort themselves and precommit to avoid moral hazard. Obviously, if bankruptcy is largely exogenous or attributable in part to quasi-rational behavior, as I argue above, then the significance of this effect fades. Again, what we know about the reality of bankruptcy in this country⁷³ and in the UK⁷⁴ suggests that a great deal, if not the overwhelming majority, of bankruptcy is exogenous. Similarly, as discussed above, Michelle White's own work suggests a variety of empirical

⁷² E.g., White, *Why Don't More Households File?*, *supra* note 27; White, *Why It Pays*, *supra* note 27.

⁷³ The basic argument of the work of Sullivan, Warren & Westbrook generally is that bankruptcy for the most part is exogenous. E.g., Sullivan, Warren & Westbrook, *supra* note 18; Sullivan, Warren & Westbrook, *supra* note 4; Warren & Tyagi, *supra* note 14. My research on credit cards lends cross-border support to that view. Mann, *Cards Data*, *supra* note 9.

⁷⁴ The Griffiths Commission Report argues that consumer bankruptcy in the UK (where total household indebtedness is even higher than it is in the USA) generally follows upon a "trigger" (such as loss of a job or change in family circumstances) followed by a "spiral" into debt that cannot be repaid. Griffiths Commission, *2005 Report*, *supra* note 37. The Griffiths Commission Report is particularly interesting because it offers a rare glance at what seems to be

scenarios in which it would be counterproductive to lower the ability of bankrupts to protect post-bankruptcy earnings.⁷⁵

It is important, however, to think about the problem more broadly. Explicitly or implicitly, all of the existing literature rests on the assumption that borrowers are better situated than lenders to avoid financial distress and bankruptcy.⁷⁶ That view might have made sense in a traditional bank lending model, where a borrower comes to a bank, sits in the banker's office, executes loan documents, receives funds, and is then free to go – unconstrained in any realistic way from later activities that might reduce the likelihood that the borrower will be able to repay the loan. In that model, for example, the bank is unable effectively to prevent the borrower from engaging in reckless future borrowing or wasting the borrowed funds on frivolous luxuries.

In the modern information-based lending world, however, it is much less plausible to view the borrowers as operating in full control to the detriment of hapless and incapable lenders. Most obviously, the modern lender (at least in this country) has access to pervasive and frequently updated information about the credit behavior of its customers.⁷⁷ For example, the modern credit-card lender has the ability to terminate the borrower's use of funds at any time by the simple expedient of refusing to permit additional uses of the card once the information available to the lender indicates that the

reliable household-level information about consumer credit, helping us to understand into how small a share of the nation's households the average amount of outstanding credit is compacted.

⁷⁵ White, *A General Model*, *supra* note 2.

⁷⁶ *E.g.*, Jackson, *supra* note 3; Adler, Polak & Schwartz, *supra* note 1.

⁷⁷ The idea is not a new one. For example, writing in 1985, Jackson presciently acknowledged the possibility that experienced lenders might develop the ability to monitor

borrower's behavior is insufficiently creditworthy. On that point, the rise of credit bureaus largely has solved the problem of multiple non-adjusting lenders harming each other's prospects without either aware of the others.

In sum, in the modern world, particularly in the context of credit card lending, the rate of default in a lender's portfolio is largely in the control of the lender. If a lender wishes to lower the rate of default in its portfolio, it can simply tighten the criteria it uses for determining when to cease advancing.⁷⁸ That tightening, of course, might not be profitable if it lowers the revenue the lender gains from loans to risky borrowers. Yet all that means is that modern lenders are optimizing their default rates in their own portfolios – balancing default losses against profits from loans to the less creditworthy potential consumers.⁷⁹

Once we recognize that they are optimizing the risk of default from a private perspective that takes no account of the externalities financial distress displaces to third parties, we have a problem that warrants the attention of policymakers. A glance at some illustrative statistics about the credit card industry is useful. Under the conventional model, increasing delinquency rates by cardholders translate directly into a loss by the

borrowing more adeptly than borrowers. Jackson, *supra* note 3, at 1400; *see* Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. Rev. 953, 976-91 (1981).

⁷⁸ As a glance at any annual report for a monoline credit card issuer will show, this is an oversimplification. Delinquencies on credit card accounts show a distinct time trend as the portfolio ages, so much of the science of managing delinquency and charge-off rates involves management over time of classes of accounts of differing ages and risk profiles. *See*, for example, Providian's discussion of its carefully implemented efforts to lower the delinquency rate in its portfolio since 2001 by shifting to higher quality borrowers. Providian 2004 Annual Report 3-5.

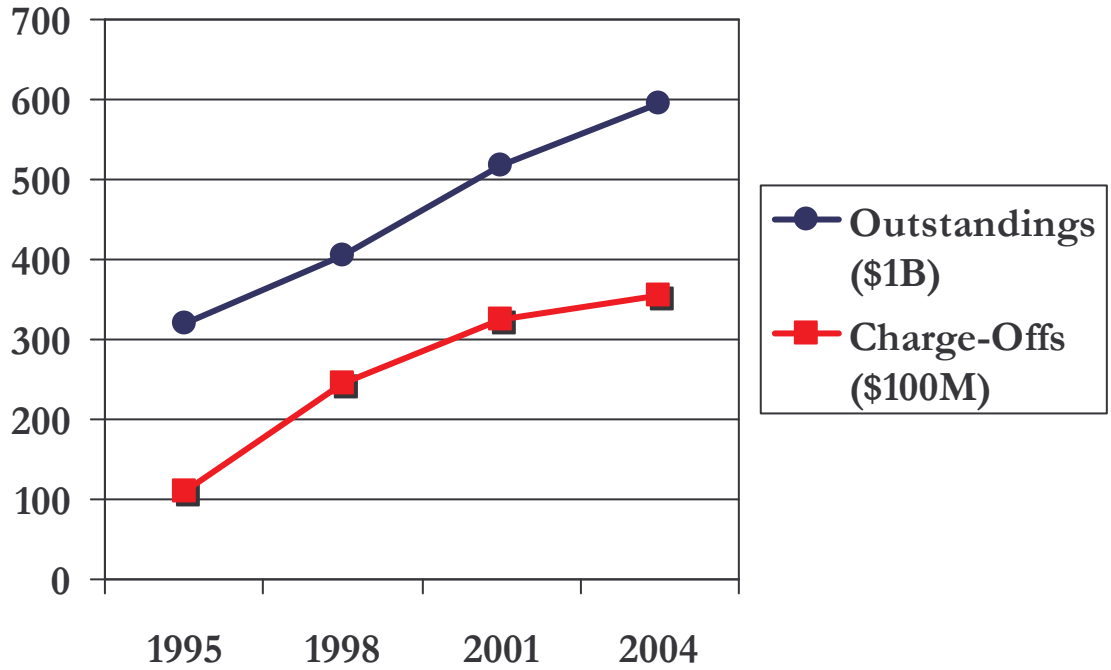
⁷⁹ As Tom Jackson noted twenty years ago, in comparing the relative ability of borrowers and lenders to bear risks, consumer borrowers (unlike, perhaps, publicly traded corporations) are

card issuers, which translates directly into increased charges borne by the cardholders that repay.⁸⁰ In a world in which lenders are optimizing default rates and externalizing losses to other parties, increased delinquency rates do not necessarily suggest that lenders should raise prices and lower output. On the contrary, to the modern credit card lender, increased delinquency rates suggest a greater number of borrowers likely to have an appetite for carrying balances at a level that is profitable for the lenders. To get a sense for the reality of the relations, consider Figure One, which sets out charge-offs and outstandings for the ten largest credit card banks over the last decade. As that figure shows, chargeoffs have been rising steadily throughout the last decade, but there is no discernible evidence that the leading lenders have cut back their lending; rather their portfolio seems to have grown in lockstep with the growth in charge-offs. Nor should we think that lenders have reacted to the increasing chargeoffs by imposing substantial increases in their interest rates. On the contrary, as shown in Figure Two, interest rates over the same period of time have fallen steadily (slightly, but steadily).

much less able to diversify the risk of financial distress than lenders. Jackson, *supra* note 3, at 1400.

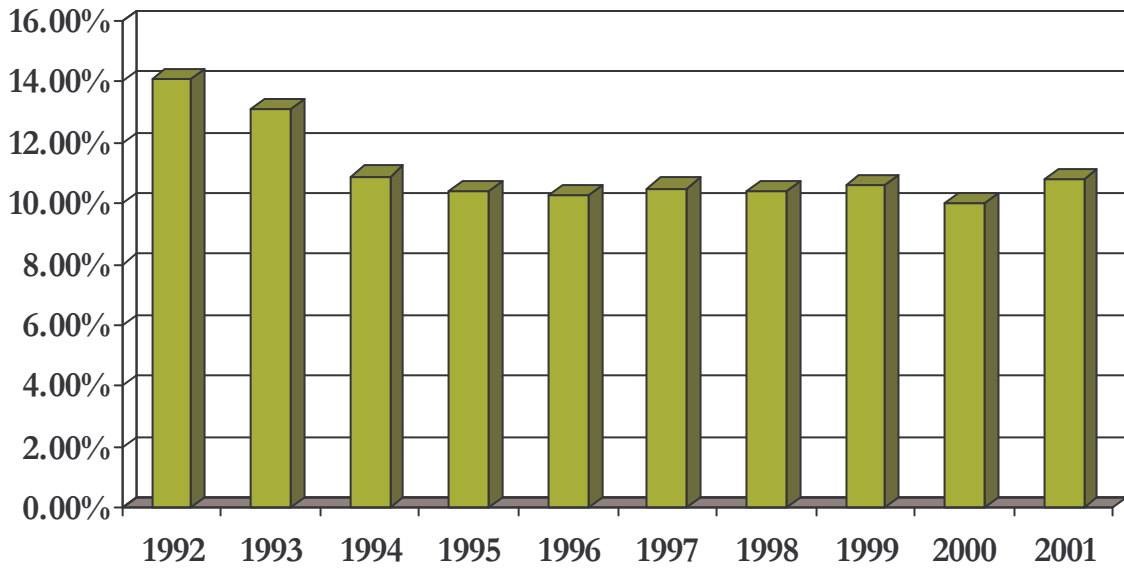
⁸⁰ See Elizabeth Warren, *The Phantom \$400*, 13 J. Bankr. L. & Pr. (2004) (describing that conventional syllogism and the implausibility of the notion that the increased charges amount to \$400 per year per family).

FIGURE ONE: LOSSES AND LENDING



Source: Nilson Report 829

FIGURE TWO: AVERAGE CREDIT CARD MARKUP



Source: Federal Reserve Statistical Release G-19.

This is not to suggest, of course, that borrowers have no control over default. Of course they do. The appropriate policy question, however, is whether they are the only party that is in a position to limit the social losses of financial distress. If both borrowers and lenders are in a position to take steps to limit those losses, then we should be asking how to allocate incentives between those two parties to minimize the net externalized costs of financial distress. We can trust the parties themselves to minimize the costs they bear between themselves, but not the losses others suffer.

Thus, to consider an analogy to payments policy, this is much like allocating losses from fraudulent use of credit cards. If all of the losses are placed on banks, they will have an incentive to use information technology to prevent those losses, but we might fear that cardholders will have inadequate incentives to take commonsense precautions to avoid theft of their card or card number. Currently, our legal system operates on the assumption that the hassle and inconvenience of card loss gives adequate incentive to cardholders, so the out-of-pocket losses from fraud are placed almost entirely on the card issuers.⁸¹

In this context, a perspective that views the experience of consumer bankruptcy as a time for celebration and reveling by the released borrowers would worry that only a truly unforgiving bankruptcy system – or perhaps penal confinement – would be adequate to prevent widespread fraud.⁸² In contrast, a perspective that views consumer bankruptcy

⁸¹ Ronald J. Mann, *Making Sense of Payments Policy in the Information Age*, 93 *Geo. L.J.* 633 (2005).

⁸² I discern such a perspective in Zywicki, *Testimony*, *supra* note 16, and LoPucki, *supra* note 19. The instinct that harsh punishment is necessary calls to mind the cadena temporal condemned as cruel by the Supreme Court in *Weems v. United States*, 217 U.S. 349 (1910).

– even in the United States in the 21st century – as a deeply humiliating and scarring personal experience would think that the event of bankruptcy alone gives a substantial protection against moral hazard, and that judges could be relied on to identify cases of overt misconduct. That perspective would shift as much of the monetary losses as possible to lenders, and in particular to adjusting lenders that can control financial distress through the ability to terminate the borrower’s ability to obtain future funds.

It is not my purpose here to make detailed policy prescriptions. Generally, the analysis suggests that subordination of the debt of controlling, adjusting creditors would be an appropriate response. As a practical matter in the United States, that suggests special rules that would subordinate the recoveries of credit card lenders to the recoveries of other general unsecured creditors. My general impression, however, is that such a rule would have a relatively minor impact, because of the large number of no-asset cases in which even general unsecured creditors would receive nothing. Thus, I am inclined to think that such a rule would make sense only as an adjunct to a tax on distressed debt of the kind that I discuss in the previous part of this essay.

B. Bankruptcy “Reform”

Against that backdrop, it seems worthwhile to consider the likely effects of the recently adopted Bankruptcy Abuse and Consumer Protection Act of 2005.⁸³

⁸³ After struggling with bankruptcy reform for 8 years, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 in April 2005, and President Bush signed the Act a few days later. The Act substantially amends the bankruptcy laws of the United States and will have its greatest impact in consumer bankruptcy cases. The legislation relating to consumer bankruptcy will make it more difficult for individuals to seek relief under chapter 7 of the Bankruptcy Code. Among other changes, the Act imposes on consumer debtors who are above the median income a complex mathematical “means testing” formula to determine whether the case should be dismissed for an abuse of chapter 7. The Act also will require the payment of

Recognizing that it is too early to know how the reforms will play out in practice, it is fair, however, to examine the policy motivations that are apparent on the face of the statute to see how they compare to the policy recommendations and theoretical frameworks that I summarize above. As a general matter, the revisions reflect acceptance of the premise that the primary empirical link of policy significance is that generous bankruptcy relief tends to increase the demand for credit but lower the incentive to repay, so that more rigorous bankruptcy relief would lead to higher repayment rates and thus lower interest rates. But even that rationale can do little to justify the statute as written. Taken seriously, that premise would suggest that the reforms should apply only to newly incurred obligations, for which interest rates presumably would be lower. Permitting lenders to use the relatively rigorous collection incentives of the new act to collect on debts already incurred under preexisting contracts seems like a windfall from an incentive perspective.

Turning to the substance of the reforms, my blunt view is that the reforms related to consumer bankruptcy seem likely to have effects directly opposed to those suggested by the analysis above. I focus on three separate points: the practical limitations on the use of Chapter 7, the practical elevation of the priority of credit card lenders, and the likelihood that the reforms as a whole will lead to later filings by distressed consumers.

The first problem is the one most apparent from the immediately preceding paragraphs, the portion of the reforms that is specifically designed to force consumers out of Chapter 7 and into Chapter 13, with a view to limiting the ability of bankrupts to

greater amounts under a chapter 13 plan for many consumer debtors and will alter provisions on exempt assets, reaffirmation of debts, and discharge of indebtedness for individuals.

discharge debts while earning a substantial post-discharge income. Quite apart from any concerns about the administrative practicality or utility of the provisions, as a matter of basic theory they seem incongruous in light of the discussion above. My analysis suggests that the system should increase the incentive of lenders to take steps to minimize the costs of financial distress that those transactions externalize. Yet these revisions in contrast are designed explicitly to shift the costs of financial distress to the borrower.⁸⁴

Second, if the general effect of the reforms is to lessen the benefits of bankruptcy, they well may cause some distressed borrowers to defer their bankruptcy filings.⁸⁵ As discussed above, what we know about consumer bankruptcy as it currently exists is that consumer borrowers probably file too late, not too early. These reforms are likely only to exacerbate that problem. The proposals that I discuss above, by contrast, are likely to cause people to file sooner by limiting the economic incentive of credit card issuers to continue lending.⁸⁶

Finally, to some degree the revisions are likely to elevate the likelihood that credit card lenders will be repaid in bankruptcy above the likelihood that other unsecured

⁸⁴ Another remarkable aspect of the reforms relates to the distinction between business-related consumer borrowing and spending-related borrowing. One thing that the revisions did not do is alter the provisions in Bankruptcy Code § 707 that limit the chapter-shifting rules to those with “primarily consumer debts.” Thus, the chapter-shifting rules by the terms will not affect individuals who have incurred debts for business purposes. The empirical evidence discussed above does suggest good reasons for the treatment of business-related lending. Still, however, there is considerable insincerity in the juxtaposition of the public policy to encourage that borrowing (and the related spending) and the subsequent harsh treatment of that borrowing in bankruptcy.

⁸⁵ It is not clear to me that the reforms will result in a substantial lessening of total filings. If filings are almost entirely attributable to serious distress, as seems likely, then the likely effect will only be a deferral, which would be evidenced by a short-term downturn in filings.

⁸⁶ In Mann, *Global Cards Policy*, *supra* note 7, I propose banning the use of universal default provisions for similar reasons.

creditors will be repaid.⁸⁷ Any such policy has a number of obvious adverse consequences. First, most obviously, credit card lenders⁸⁸ are more able to adjust to evidence of distress than other unsecured creditors.⁸⁹ So, for example, provisions that make more credit card debts nondischargeable place those lenders on an even playing field with child support and alimony claimants. Because the bill does nothing to *increase* the assets in bankruptcy estates, those claimants will be harmed even with enhanced priority positions in bankruptcy. The discussion above suggests that an optimal bankruptcy/finance policy would be searching for ways to increase the incentives of adjusting creditors with the ability to control their borrowers. If credit card lenders are the plainest examples of such a lender, and if credit card lenders also are the group whose

⁸⁷ The principal example here is § 310, which revises Bankruptcy Code § 523 to broaden the types of credit card debt that are presumptively not dischargeable. Among other things, any cash advance of more than \$750 will raise that presumption. So, for example, if a borrower less than 90 days before bankruptcy obtains a cash advance to pay rent or a medical bill or to shift balances from one credit card to another, the previously dischargeable debt now will become presumptively nondischargeable. It is difficult to know how serious that problem is. One UK agency estimates that borrowing money from one creditor to pay off another is a common practice in half of households suffering from financial distress. Griffiths Commission, *2005 Report*, *supra* note 37.

⁸⁸ It is perhaps most notable that a variety of statutes that might have limited the prerogatives of credit card lenders or remedied more serious abuses in the process received little serious attention from Congress. Consider, for example, Credit CARD Act of 2005, S. 499, 109th Cong. (prohibiting various credit card practices, enhancing disclosures, and the like); Bankruptcy Fairness Act, S. 329, 109th Cong. (increasing priority claims for nonadjusting creditors); Billionaire's Loophole Elimination Act, H.R. 1278, 109th Cong. (limiting protection for asset protection trusts); Medical Bills Interest Rate Relief Act, H.R. 1238, 109th Cong. (amending TILA with respect to credit card transactions related to medical bills).

⁸⁹ As discussed above, the economics of the current situation give lenders an incentive to manage their lending in a way that optimizes the results of their entire portfolio, which might lead in many cases to greater amounts of lending at higher rates with less individualized assessments of particular loans. I am generally skeptical of reforms (like the EU's responsible lending initiative) that attempt to specify rules for lending; discussion of that topic in the annual reports of credit card issuers makes me doubt the ability of regulators to perform that task effectively. A more appropriate response, I think, is to alter the system so that the issuers designing their underwriting policies will internalize more of the costs of the distress that arises from their loans, and thus figure out the most sophisticated methods for lending less riskily.

lending most directly promises to create externalities of financial distress, then reforms should go in the opposite direction. Any reform that transfers value from nonadjusting creditors to adjusting creditors only exacerbates the externalities of the bankruptcy process by imposing losses on those that have not had an opportunity to spread them over a mass of voluntarily priced transactions. Thus, it would make much more sense to expand the category of priority unsecured claims to include more comprehensively the categories of nonadjusting creditors that currently share priority with adjusting credit card lenders. The revisions that directly benefit credit card lenders might be slight in effect, but still reflect a move in the wrong direction.⁹⁰

V. CONCLUSION

History teaches us that a country that is committed to tolerating consumer spending as an engine of broader economic growth must provide some safety valve for the distress of those who do not succeed in the market economy. As our theories of those markets become more nuanced, and as our understanding of the empirical reality becomes clearer, the time has come when we are in a position to design policies that have a real prospect of cushioning the fall of those in distress and limiting the burdens their distress imposes on the rest of us.

Thus, I propose two principal alterations in the way we think about credit and bankruptcy institutions. First, the link between credit card spending and financial distress

⁹⁰ Indeed, the only significant “reform” with regard to lending industry disclosure is the requirement that credit card companies provide the consumer with an “800” number to call and unrealistic examples of credit card debt paydowns (which may not reflect the actual situation of the debtor and thus prove misleading), as well as a series of boilerplate warnings regarding real estate loans and teaser rates.

suggests payment systems reforms designed to curtail the instrument-induced risk and credit market reforms designed to internalize the costs of financial distress to the transacting parties. Here I suggest rules that would increase the minimum repayments on credit card loans and tax distressed debt held by credit card issuers. Second, I suggest that there is little evidence that the American “fresh start” bankruptcy system has imposed any substantial “bankruptcy tax” on responsible debtors in this country over the past 25 years, so that reforms premised on concerns about stigma or the robustness of credit markets should give way to the realities of tolerating (indeed encouraging) risky behavior by consumers and entrepreneurs alike.