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February 2, 2009

Congressional Research Service

Report 98-277

*BANKRUPTCY AND CREDIT CARD DEBT: IS THERE
A CAUSAL RELATIONSHIP?*

Mark Jickling, Economics Division

Updated March 19, 1998

Abstract. This report explores the relationship between credit card debt and the fast-growing rate of personal bankruptcy. Is the bankruptcy code so biased towards debtors that it encourages irresponsible and/or fraudulent credit card borrowing, or have lenders themselves been reckless in issuing credit cards to households with limited financial resources and sophistication?

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Abstract

This report explores the relationship between credit card debt and the fast-growing rate of personal bankruptcy. Is the bankruptcy code so biased towards debtors that it encourages irresponsible and/or fraudulent credit card borrowing, or have lenders themselves been reckless in issuing credit cards to households with limited financial resources and sophistication? Legislation before the Congress (H.R. 2500, H.R. 2650, and S. 1301) proposes reforms in bankruptcy law that would benefit credit card lenders by requiring certain debtors to repay their debts out of future income. (For an analysis of these proposals, see CRS Report 98-69A.) This report, which will be updated only if significant new research is published or if new data become available, consists primarily of economic analysis and does not presuppose an extensive knowledge of bankruptcy law.

Bankruptcy and Credit Card Debt: Is There A Causal Relationship?

Summary

Personal bankruptcy filings now exceed one million per year. Why should bankruptcies have risen to record levels during a period when the economy has enjoyed two of the longest peacetime expansions in history, with unemployment, inflation, and interest rates all falling? Something must have changed in household finance; credit cards are among the “usual suspects.”

Credit cards figure prominently in the debate over bankruptcy reform. Credit card lenders argue that bankruptcy makes it too easy for debtors to avoid paying their debts, creating an incentive for reckless or fraudulent borrowing and exacerbating recent losses to credit card loan portfolios. They support legislation (H.R. 2500 and S. 1301) that would require some debtors to repay a portion of what they owe. Opponents of such proposals, including some consumer groups, argue that the high-power marketing campaigns of credit card issuers amount to an irresponsible extension of credit to households with low incomes and little financial sophistication, many of whom are then thrust into bankruptcy by any unforeseen economic trouble.

Does bankruptcy cause excessive losses to lenders, or do lending practices cause bankruptcies? Credit card debt has grown rapidly since the early 1980s, but it is still a small share (less than 11%) of all household debt, which is dominated by mortgage and home equity debt. However, the interest charged on credit cards is high, and, moreover, it is “sticky,” that is, credit card lenders have not cut their rates when the general level of interest rates falls. Reasons for this stickiness may lie in structural and permanent features of the market, or in unique historical circumstances in the credit card industry’s development; in any case, a dollar of credit card debt is more expensive than a dollar of other debt.

Since 1989, the aggregate debt burden (debt payments as a percentage of income) of American families has been flat. However, the debt burden has fallen for upper income families and risen for low-income families. Financial distress (when more than 40% of income goes to debt service) has also increased among lower-income families. Have credit cards played a role in these trends? The debt burden arising specifically from credit cards appears to be minor: 0.5% of income in 1995, but somewhat higher and rising for low-income households. Could credit card borrowing by low-income families, though small in the aggregate, be a straw that broke the camel’s back and a source of increased bankruptcy filings?

The percentage of families using credit cards to borrow has increased since 1983, with lower-income families leading the rise. However, the median amount borrowed by low-income families has not risen significantly: the expansion of credit card loan volume is primarily attributable to upper-income borrowers increasing their balances. And for these borrowers, the overall debt burden has been falling.

The available aggregate data do not show that credit card debt has caused a major shift in U.S. household financial conditions. Many bankruptcy filers no doubt have unusually high amounts of credit card debt, but statistical information about their overall financial circumstances does not exist.

Contents

Credit Cards and Household Finances	4
The Distribution of Household Debt	4
Why Are Credit Card Interest Rates So High?	5
Historical Accidents	8
Consumer Indifference to Interest Rate Levels	9
Switching Costs	10
Household Debt and Access to Credit Cards	11
Trends in the Aggregate Household Debt Burden	11
Competition and Access to Credit Cards	13
Summary of Data and Conclusion	16

List of Figures

Figure 1. Credit Card Loan Charge-offs (Percent) and Personal Bankruptcy Rate (Filings per 1,000 population), 1984-1997*	2
Figure 2. Revolving Credit Outstanding by Holder, 1980-1997	5
Figure 3. Selected Interest Rates, 1980-1997	6

List of Tables

Table 1. Major Categories of Household Debt, 1980-1997	4
Table 2. Net Pre-Tax Earnings as Percent of Outstanding Balances for Selected Types of Bank Credit	7
Table 3. Measures of the Family Debt Burden:	12
Table 4. Debt Burden from Credit Card Debt (Percent of Income Consumed by Debt Service Payments)	13
Table 5. Family Credit Card Debt, 1989-1995	15

Bankruptcy and Credit Card Debt: Is There A Causal Relationship?

A number of bills before the 105th Congress (H.R. 2500, H.R. 3150, and S. 1301) would subject individuals filing bankruptcy petitions to a means test. If their income were sufficient to repay a certain percentage of their debts, they would be required to file a Chapter 13 “wage earner” bankruptcy, under which they would turn over their income (after deductions for living expenses) to a court-appointed trustee for distribution to their creditors. Chapter 13 is available under current law, but only about 30% of bankruptcy petitioners choose it. The rest prefer Chapter 7, where one may give up certain assets (to be sold for the creditors’ benefit) and remaining unpaid debts (with certain exceptions) are immediately discharged, or canceled, leaving one free to make a “fresh start” with future income unencumbered.

If this “needs-based” bankruptcy proposal is enacted and works as intended¹, and significant numbers of bankruptcy filers repay portions of their outstanding debt in Chapter 13, among the principal beneficiaries will be credit card lenders. Unlike loans that are secured by liens on the borrower’s assets, such as home mortgages and car loans, credit card lending is unsecured. In Chapter 7 bankruptcy proceedings, unsecured creditors are the last to share in the liquidation of a debtor’s assets, and unsecured debt is the first to be discharged. (Some forms of unsecured debt, such as student loans, are given priority by the bankruptcy code, and are not discharged. Secured creditors, on the other hand, retain their right to foreclose on property pledged as collateral even after bankruptcy.) In a typical Chapter 7 consumer bankruptcy case, the banks and other firms to whom credit card debt is owed see their claims extinguished, and get nothing in return.² And their claims may often be a substantial part of the debt that is discharged by the bankruptcy court, since credit cards function as a lender of last resort for many of those in financial distress.³

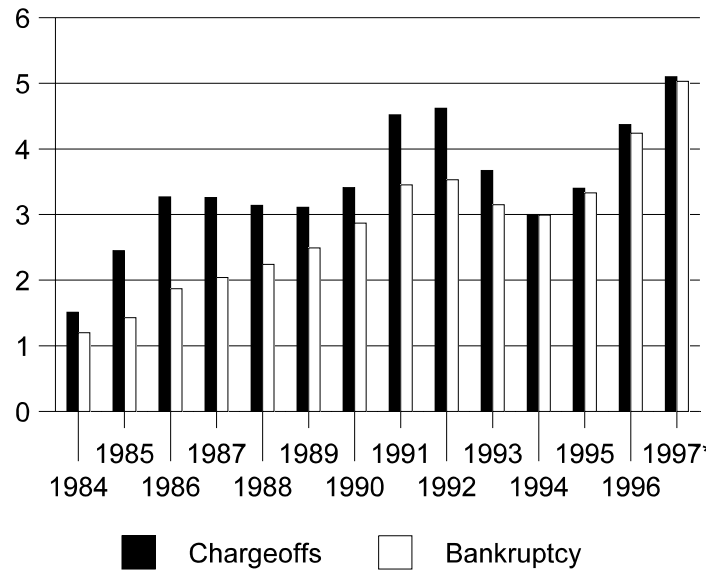
Given the nature of credit card debt and its treatment in bankruptcy, one would expect some correlation between the incidence of personal bankruptcy and the losses experienced by credit card lenders. Figure 1 below compares the percentage of credit card loans that commercial bank have charged off (given up for lost) each year since 1984, with the annual number of personal bankruptcy filings per 1,000 population.

¹For an analysis of the bills, see CRS Report 98-69 A: *Needs Based Consumer Bankruptcy: Proposals Before the 105th Congress*, by Robin Jeweler.

²About 95% of nonbusiness Chapter 7 cases are “zero-asset” bankruptcies, where none of the debtor’s property is sold for creditors’ benefit. See: McHugh, Christopher. *1996 Bankruptcy Yearbook and Almanac*. Boston, New Generation Research, 1997. P. 39.

³Current and comprehensive data on the origin and size of debts in personal bankruptcy cases are not available. The bills above would direct the courts to compile such statistics from bankruptcy petitions.

Figure 1. Credit Card Loan Charge-offs (Percent) and Personal Bankruptcy Rate (Filings per 1,000 population), 1984-1997*



Source: FDIC and U.S. Courts. * Jan.-Sept., annualized.

The two figures track each other roughly until 1994, when they become virtually identical. This correlation helps explain why credit cards have been at the center of the debate over the ongoing “epidemic” of personal bankruptcy. The increase in personal bankruptcy since the early 1980s — during a period when the United States has enjoyed two of the longest economic expansions ever recorded in peacetime — is puzzling. No single factor can be identified with confidence as the principal cause, but something must have changed in household finance.⁴ Credit cards are among the usual suspects. Even though credit card debt represents a fairly small fraction of total household debt,⁵ its rate of growth since 1980 has been the fastest of any component of that total. In addition to growth in the volume of lending, the credit card industry has been characterized by rapid change in other areas:

- the number of major credit and debit cards in circulation has grown from just over 100 million in 1980 to about 500 million. Ten million more American families had credit card debt in 1995 than in 1983,⁶

⁴For a review of the suggested causes of increased bankruptcy filings, see CRS Report 97-637 E, *One Million Personal Bankruptcies in 1996: Economic Implications and Policy Options*, by Mark Jickling.

⁵Credit card debt outstanding in September 1997 was less than 11% of total household debt. (See table 1 on page 4 below.)

⁶According to the Federal Reserve’s *Survey of Consumer Finances*.

- the proportion of households with access to this form of credit has increased, following direct mail and telephone solicitations by card issuers that have numbered in the billions, and
- technology has created new uses for the cards — at the gas pump, in foreign cities, in supermarkets, on the Internet, etc. — and has made their use more convenient — for instance, clerks no longer look though a ledger of bad or stolen card numbers before each sale — so that they have become nearly indispensable to many households, even those that do not use the cards to borrow.

The relationship of credit cards to bankruptcy is controversial. Credit card lenders argue that the current bankruptcy code is too lenient toward debtors and encourages abuse. Since a quick, easy, and relatively painless way to avoid repayment of unsecured debt is available, many consumers are said to choose to file bankruptcy rather than live within their means. The existence of the bankruptcy option, following this line of reasoning, causes irresponsible and/or fraudulent behavior by borrowers, which inevitably drives up loan losses. Credit card issuers have been strong supporters of “needs-based” bankruptcy and other reforms designed to shift the costs of personal bankruptcy from creditors to debtors.⁷

Opponents of such proposals, however, see the causal relationship flowing in the opposite direction. They argue that the marketing tactics of credit card lenders — the ubiquitous mass mailings, offers of “pre-approved” lines of credit, low initial interest rates, etc. — amount to force-feeding a very expensive form of credit to households with little financial sophistication. Many such households take on debt burdens that they cannot repay, or which at least put them closer to the edge, so that any setback to their financial situation drops them into bankruptcy court. If lenders experience high loss rates, in this view, they are only reaping what they have sown, and in any case, they are compensated for risk by the high interest rates they charge.

Does bankruptcy cause excessive losses to lenders, or do lending practices cause bankruptcies? This report considers the evidence that may shed light on these questions. The following sections examine (1) the significance of credit card debt in terms of the total picture of consumer finance, (2) the growth of, and competitive conditions in the credit card industry — in particular, the issues of why credit card interest rates are so high and whether the credit card market has expanded principally through marketing to low-income, high-risk households — and (3) changes in the debt burdens of American households. (Debt burden, or debt service payments as a share of total income, is an indicator of the ability to pay.)

⁷For examples of these arguments, and rebuttals, see: U.S. Congress. Senate. Committee on the Judiciary. Subcommittee on Administrative Oversight of the Courts. *The Increase in Personal Bankruptcy and the Crisis in Consumer Credit*. Hearing, 105th Congress, 1st session, April 11, 1997. (S. Hrg. 105-89) 154 p. and: U.S. Congress. House. Committee on Banking and Financial Services. *Consumer Debt*. Hearing, 104th Congress, 2nd session, September 12, 1996. (Serial No. 104-74) 458 p.

Credit Cards and Household Finances

The Distribution of Household Debt

Bankruptcy, almost by definition, is a condition of excess debt. Table 1 below presents aggregate debt figures (dollar amounts outstanding) for the major categories of household debt: home mortgages (including home equity loans) and consumer credit, the latter of which is broken down into (1) auto loans, (2) credit card, or revolving credit,⁸ and (3) “other,” which includes loans for mobile homes, boats, trailers, education, vacations, etc.

Table 1. Major Categories of Household Debt, 1980-1997

	Home		Consumer Credit						Total
	Mortgages		Auto Loans		Credit Cards		Other		
	\$ Bill.	% of Total	\$ Bill.	% of Total	\$ Bill.	% of Total	\$ Bill.	% of Total	
1980	904.9	71.8	112.0	8.9	58.5	4.6	184.9	14.7	1260.3
1985	1378.8	69.5	211.7	10.7	131.6	6.6	260.5	13.1	1982.6
1990	2455.0	75.3	283.9	8.7	250.9	7.7	269.2	8.3	3259.0
1995	3358.5	74.9	367.1	8.2	464.1	10.4	291.6	6.5	4481.3
1997*	3767.5	75.4	409.3	8.2	524.3	10.5	293.1	5.9	4994.2

* Third quarter; other figures end-of-year.

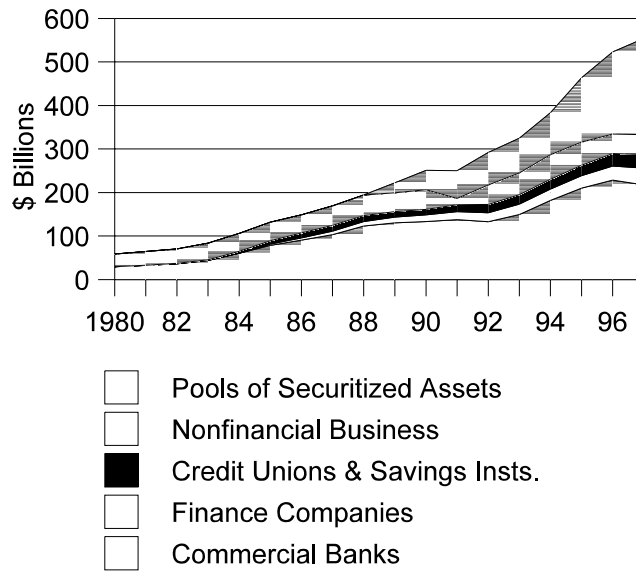
Source: Federal Reserve. *Balance Sheets for the U.S. Economy* and Release G.19.

These figures — which are not adjusted for inflation — show that revolving credit has been the fastest growing type of household debt since 1980. Revolving credit, in turn, is dominated by bank credit card lending, as is shown in figure 2 below, which sets out revolving credit by holder. Commercial banks and pools of securitized assets (loans which have been packaged as bonds and sold to investors, and which are no longer carried on the originating banks’ books) account for about 80% of the total loan volume.

However, revolving credit remains a relatively small fraction of total household borrowing, which continues to be dominated by home mortgage debt. Since 1980, households have taken on about \$465 billion in additional revolving card debt, but

⁸Revolving credit includes not only bankcards, such as Visa and Mastercard, but also cards issued by oil companies and retailers.

Figure 2. Revolving Credit Outstanding by Holder, 1980-1997



over the same period mortgage (and home equity) loans outstanding have grown by nearly \$3 trillion.

Source: Federal Reserve. Release G.19.

Why then does the bankruptcy debate focus on credit card borrowing rather than on mortgage debt? One answer is that mortgages are little affected by the bankruptcy process: the lender's right to foreclose if the loan is not repaid survives bankruptcy. Another answer, more germane to this report, is that credit card interest rates are among the highest, if not the highest, charged by mainstream lenders. A dollar of credit card debt will require a greater share of the borrower's income than a dollar of other debt. (Credit card debt became even more expensive relative to mortgage debt when the Tax Reform Act of 1986 took away the deductibility of credit card interest payments.) It may be, therefore, that credit card debt raises debt burdens disproportionately to its share in total household borrowing.

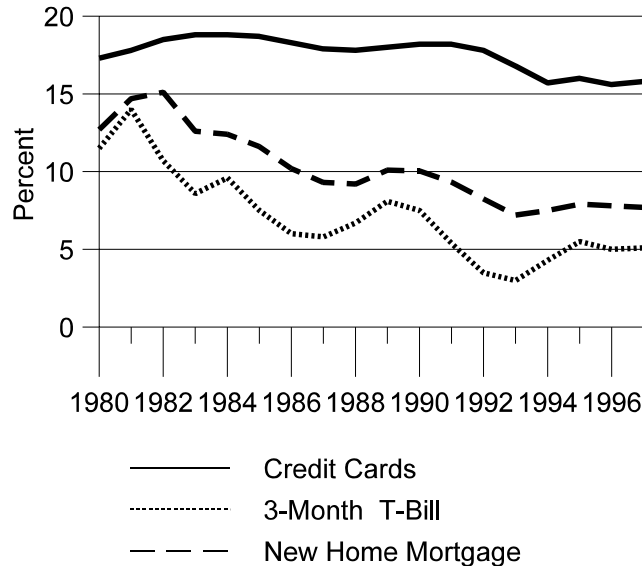
Why Are Credit Card Interest Rates So High?

There are two parts to the question of credit card interest rates. The first is: why have rates been so high? The second is: what impact do these rates have on household finances? That is, are they so high that they cause financial distress and lead to bankruptcies? The first question has been the subject of much research independent of the bankruptcy issue. That research is summarized here.

The price of a loan — the interest rate charged to borrowers — is determined by several factors. The interest rate must yield enough revenue to cover the lender's costs (cost of funds, administrative costs, etc.) and it must include a risk premium to cover the possibility of borrower defaults. The size of the premium varies according to the lender's perception of the credit risk involved in a particular loan or class of loans. Credit card loans are at the riskier end of the scale. They are unsecured, as

noted above, and they are relatively unsupervised once the initial decision to issue a card is made. A borrower can — indeed, is likely to — increase the size of his debt as his creditworthiness declines.

Figure 3. Selected Interest Rates, 1980-1997



Source: Federal Reserve.

A high risk premium means that credit card interest rates will be high relative to other rates.⁹ However, one would still expect the absolute level of credit card rates to fluctuate as lenders' costs go up and down. This has not happened. As figure 3 above shows, credit card rates have been not merely high, but "sticky." They have not followed the general trends in interest rates, which raise and lower lenders' cost of funds.

If lenders' interest costs go down and their interest revenues do not, their profits will increase, other things being equal. The table below presents data on the profitability of credit card operations of depository institutions.¹⁰ Over the period 1974 through 1996, credit card lending was the least profitable of the four types of loans. However, the standard deviation of credit card profits was much greater than for other types of lending: profits tend to be quite high or very low, even running into negative returns. This is what one would expect from any high risk/high reward business operation: a volatile rate of return.

⁹Administrative costs are also higher for credit card lending than for other types of loans, because of the large numbers of accounts and transactions. See: Canner, Glenn B. and Charles A. Luekett. Developments in the Pricing of Credit Card Services. *Federal Reserve Bulletin*, v. 78, September 1992. P. 658.

¹⁰See also U.S. General Accounting Office. *U.S. Credit Card Industry: Competitive Developments Need to be Closely Monitored*. (GAO/GGD-94-23) April 1994. P. 19.

Table 2. Net Pre-Tax Earnings as Percent of Outstanding Balances for Selected Types of Bank Credit

Period	Credit card	Mortgage	Commercial	Installment
1974-1996				
Average (%)	1.77	2.48	2.25	2.15
Standard Deviation	2.05	0.71	1.21	0.59
1983-1993				
Average (%)	2.99	2.60	1.42	2.35
Standard Deviation	0.95	0.49	0.52	0.43

Source: Federal Reserve. *The Profitability of Credit Card Operations of Depository Institutions*. (Annual Report to Congress.) August 1997. Table 2.

In a competitive market, the long-term returns for different types of lending ought to be about equal. The fact that credit card returns are the lowest over 1974-1996 may simply indicate that the time period selected includes two downturns in the credit card lending cycle: 1980-81, when returns were low, and 1995-96, when they were actually negative (-2.93% in 1995 and -3.75% in 1996).

The 1973-1996 performance of credit card profits contrasts strikingly to the period beginning in 1983 (at the end of the recession of the early 1980s) and ending in 1993 (before the onset of the record charge-off rates of the last few years). Over that 11-year period, credit cards' average profitability was the highest of the four lending operations, while the variability of returns was half that of the longer period. During the shorter period, the average interest rate paid by credit card borrowers was stable, despite a downward trend in the general level of interest rates.

The combination of above-average profits and rigid prices is unusual. If above-average returns are available, new competitors should enter the market and, by competing for market share, drive prices down until profit levels fall into the normal range. New competitors did enter the market, but they did not compete on price. There was considerable suspicion of price-fixing in the credit card industry; in 1991 the Senate passed a measure that would have set a ceiling on credit card rates.¹¹

To most economists, it seemed unlikely that anti-competitive collusion, or price fixing, could explain the stickiness in interest rates. The credit card industry consists of thousands of lenders — 6,800 in 1997 — each of whom decides individually what rate to charge consumers.¹² There are no significant barriers to

¹¹Senate Amendments 1333 and 1334 to S. 543 (102nd Congress).

¹²In fact, there is considerable variation in the rates charged by individual lenders; it is (continued...)

entry: it is relatively simple and inexpensive for any bank to become a member of the Visa or Mastercard associations. Nonbank corporations like General Motors and AT&T also issue bankcards. Competition is also present from other cards, like Sears' Discover and American Express's Ultima, from bank ATM cards, and from cards issued by merchants. Several explanations for why credit card rates did not fall have been put forward. These focus on (1) particular historical circumstances in the development of credit card markets and, with more direct relevance to the credit card/bankruptcy question, (2) consumer behavior and (3) non-price competition.

Historical Accidents. A number of unique historical circumstances have been suggested as reasons why credit card rates remained high and inflexible between 1983 and 1993.¹³

- Until the early 1980s, interest rates were capped by state usury ceilings. Because of inflation, credit card rates during the 1970s were generally set at the legal maximum; thus, there was no experience of price competition based on interest rates when the limits were removed.
- Capital expenditures related to computerization in the industry may have been high in the 1980s, resulting in above normal administrative costs.
- The heavy demand for credit as the recession of 1980-82 ended may have allowed lenders to increase their loan volume as much as they wished without having to compete for market share.
- Banks may have overestimated the risk premium by failing to anticipate that the expansion of the 1980s would last as long as it did.
- The risk premium for credit card loans may have increased in tandem with the rise in bankruptcy rates (shown in figure 1 above), with the result that rates held steady as the cost of funds declined.

Taken together, these factors suggest that, in normal times, credit card interest rates will rise and fall as other rates do, and that recent rate rigidity does not signal a failure of competition. In other words, the behavior of rates and profits during the 1983-1993 period was an anomaly that will not be repeated. The evidence to date on this claim, however, is mixed: the average rate declined from the 17%-18% range to 15%-16% between 1992 and 1994, but has fluctuated very little since. However, other interest rates have been relatively stable since then as well. Other analyses of rate rigidity focus on permanent features of the credit card market.

¹²(...continued)

the *average* rate that has been inflexible. Some lenders adjust their rates as the general level of interest rates changes, while others offer lower rates to selected customers. The mystery is why such lenders do not dominate the market, and why competition does not force others to emulate them.

¹³This analysis draws heavily on Canner and Lockett, *op. cit.*, and Ladermann, Elizabeth. What's Special About Recent Credit Card Problems? *Journal of Lending and Credit Risk Management*, v. 80, September 1997. P. 21-24.

Consumer Indifference to Interest Rate Levels. Lawrence Ausubel, in a 1991 article that has become a touchstone for much subsequent research on the topic, sees in the persistence of high rates and high profits a failure of competition.¹⁴ Credit card issuers, he concludes, have exercised market power, behaving like monopolists despite a market structure (easy entry, many sellers) in which competitive conditions ought to prevail. His explanation is based upon consumer behavior: users of credit cards have not acted in accordance with the assumptions that underlie economic models of competition.

In other words, consumers have not responded to lower interest rates, removing the incentive for lenders to compete on price. This seems paradoxical. Why would borrowers not flock to the lender with the lowest interest rates? In his answer, Ausubel divides credit card applicants into two groups: one group expects to borrow and pay interest, the second expects to use the card only for convenience and to pay the bill in full each month. The first group is sensitive to the interest rate charged; the second is not, because its members do not expect to pay any interest at all.

Why do banks not compete by lowering interest rates to attract as many of the first group as possible? There are two reasons. First, people who don't mind borrowing at high interest rates are likely to be poor credit risks. They may be in financial distress, they may be consumers who are unwilling to pace their level of consumption to their incomes, or they may be financing some risky entrepreneurial project for which they cannot secure credit elsewhere. Lenders face an adverse selection problem: if they lower interest rates, they will find themselves with a riskier pool of loans.

Second, and most important to Ausubel's analysis, many of the second group do end up borrowing, contrary to their expectations. In consumer surveys, about half of households claim that they always or nearly always pay their credit card bills in full each month. Banks, however, report that about 75% of credit card accounts incur interest charges.¹⁵ This disparity suggests that a large number of credit card borrowers do not act in their self-interest (by demanding low interest rates) because (1) they do not expect (*ex ante*) to borrow, and (2) they are unwilling to admit to themselves (*ex post*) that they are borrowing, or perhaps expect their indebtedness to be short-lived.

These “unexpected” borrowers are the credit card companies' preferred customers, but, since they do not think of themselves as borrowers, lenders cannot attract them by lowering interest rates. These consumers will focus instead on such features as the annual fee charged, the length of the grace period before interest is assessed, the credit limit, and various “enhancements” — rebates, frequent flier miles, and the like. In sum, from the lender's perspective, cutting rates is counterproductive for two reasons:¹⁶

¹⁴Ausubel, Lawrence. The Failure of Competition in the Credit Card Market. *American Economic Review*, v. 81, March 1991. P. 50-81.

¹⁵Ibid, p. 71-72.

¹⁶Actually, three reasons: no firm likes to cut prices, and for credit card lenders it is particularly painful because lowering rates across the board reduces income from all
(continued...)

- low rates attract less reliable borrowers, with the undesirable result of increasing the lending institution's credit risk exposure; and
- the best credit risks ignore offers of lower rates.

This analysis runs counter to a fundamental assumption about how markets work: that consumers can make rational decisions in their own economic self-interest. It requires not only that many credit card users make an initial mistake ("I won't use the card to borrow"), but that they keep making essentially the same error ("I will pay off the whole debt this month and won't have to pay interest next month"). The notion of persistent economic irrationality on the part of large numbers of consumers, which ought not to exist in conventional microeconomics, may have implications for the high rate of personal bankruptcy. Consumer groups who attribute bankruptcies to over aggressive marketing of credit cards often portray consumers as victims of forces and urges they cannot control. Credit counseling, which both lenders and consumer groups favor, does not involve just the techniques of balancing a household budget, but at times mimics Alcoholics Anonymous and other self-help groups that operate through catharsis and spiritual transformation. For example:

Overspending with credit cards, says the Consumer Federation of America, is an obsession that can get out of control...."If you want to see a grown person cry, sit in on one of my counseling sessions and watch me cut up the credit cards," says Betty Matthews, a consumer credit counselor. "Yes, we do. We cut them in half."¹⁷

Ausubel's analysis does account for the stickiness of credit card interest rates, but there is another explanation for the failure of consumers to demand lower rates, an explanation that is consistent with the assumption of consumer rationality.

Switching Costs. Consumers paying interest on an unpaid credit card balance have an incentive to seek out lower rates. The bigger the balance, the stronger is the incentive. However, consumers who owe a large amount on their current card (and who would benefit most from a lower interest rate) may face switching costs, as follows. If they try to open an account with a credit card issuer offering a lower rate, that issuer will not know whether their intention is to refinance their existing debt or to take on additional debt. As a result, their applications are more likely to be turned down. In addition, switching cards may involve giving up favorable treatment from the present lender, such as higher credit limits granted to those with good long-term repayment records. From the lender's point of view, the adverse selection problem again emerges: the applicants responding to offers of lower rates are likely to be those whose debt levels are already high.¹⁸

¹⁶(...continued)

outstanding loans (unlike, say, home mortgages, where a lower rate applies only to credit extended after the rate cut).

¹⁷Koch, Kathleen. Credit Card Debt 'Crushing Millions,' Group Says. *CNN Interactive*, December 16, 1997.

¹⁸For a full development of the switching costs argument, see: Calem, Paul S., and (continued...)

The switching costs argument posits that consumers are not irrationally indifferent to high interest rates, but that they face obstacles when they try to obtain lower rates. The “pre-approved” credit may not be approved after all. However, the explanatory power of this argument is challenged by anecdotal evidence of widespread “card surfing,” the practice of switching accounts rapidly from one card to another to take advantage of low rates offered for some introductory period.¹⁹

To summarize, each of the explanations for rate stickiness has problems, but all imply that high rates need not signify illegal collusion among lenders. However, even though lenders have sound and plausible reasons for maintaining high rates, the question remains what impact those rates have on consumer finances. The next section considers the part credit card debt plays in the aggregate household debt burden.

Household Debt and Access to Credit Cards

Trends in the Aggregate Household Debt Burden

To a family in financial trouble, the amount of debt is generally more important than its composition, and the amount of debt service payments required month by month is more important than the amount outstanding. What has happened to the total debt burden during the ongoing surge in personal bankruptcy filings? The Federal Reserve’s latest *Survey of Consumer Finances* includes information on debt ratios, that is, the relationship of debt service payments to total income. Table 3 presents these data for 1989, 1992, and 1995, broken down by family income level. The table also includes, as a measure of families in financial distress, the percentage of families whose debt payments exceed 40% of their incomes.

The aggregate debt burden for all families, as measured by the ratio of debt payments to total income, has been essentially constant since 1989. Within the income distribution, however, there has been a shift: families with incomes below \$50,000 devoted more of their incomes to debt payments in 1995 than in 1989, while those with incomes above \$50,000 devoted less. This need not mean that upper-income households are reducing their aggregate debt levels — in the case of credit card debt, as will be seen below, they clearly are not. It may mean instead that their incomes are growing faster than their debts. Conversely, those in the lower part of the income distribution may have experienced either falling incomes or rising debts (or both). There is a question, in other words, whether these trends in the burden of debt follow from changes in the pattern of borrowing or from increasing income inequality.

Table 3. Measures of the Family Debt Burden:

¹⁸(...continued)

Loretta J. Mester. Consumer Behavior and the Stickiness of Credit Card Interest Rates. *American Economic Review*, v. 85, December 1995. P. 1327-1336.

¹⁹Bailey, Jeff, and Scott Kilman. Here’s What’s Driving Some Lenders Crazy: Borrowers Who Think. *Wall Street Journal*, February 20, 1998. P. A1.

**Ratio of Debt Payments to Income and Families in Financial Distress,
1989-1995**

Income	Aggregate Debt Ratios (Debt Payments / Income)			Families with Debt Payments Greater Than 40 % of Income		
	1989	1992	1995	1989	1992	1995
All Families	15.6	15.8	15.4	10.9	11.6	11.1
< \$10,000	16.2	17.1	21.1	25.6	28.9	26.9
\$10-24,999	12.7	16.5	16.1	13.9	16.0	16.9
\$25-49,999	16.7	17.0	17.2	10.6	9.7	8.5
\$50-99,999	17.4	16.0	16.7	5.7	4.7	4.3
> \$100,000	14.0	14.2	11.9	6.7	4.5	4.1

Source: Federal Reserve. *Survey of Consumer Finances, 1995.*

Turning to the proportion of families in financial distress, a corroborating pattern is observed. The percentage of families who spend more than 40% of their incomes on debt service has risen in the lower income brackets and fallen in the upper. The dividing line however, is now at the \$25,000 income level, rather than \$50,000. The figure for all families is again roughly constant.

The observation that debt burdens and financial distress have both been rising for lower-income families suggests a source of the rising numbers of bankruptcy filings.

To what extent has credit card debt contributed to these trends? Table 4 below shows the debt burden arising specifically from credit card debt. Again, the measure is debt service payments divided by total family income.

The data in table 4, like those in table 1 above (showing the dollar value of different forms of household debt), suggest that credit card debt is a minor factor in the overall household finance picture. For all households, debt service on credit cards consumes only one-half of 1% of family income in the latest survey. That figure has grown since 1989, and it is inversely related to family income (just as the overall debt burden is), but even for the poorest families it is a small fraction of income.

**Table 4. Debt Burden from Credit Card Debt
(Percent of Income Consumed by Debt Service Payments)**

Income	1989	1992	1995
All Families	0.2	0.4	0.5
< \$10,000	0.2	0.8	1.3
\$10-24,999	0.3	0.6	1.0
\$25-49,999	0.4	0.6	0.7
\$50-99,999	0.3	0.4	0.6
> \$100,000	0.1	0.1	0.2

Source: Edelberg, Wendy, and Jonas D.M. Fisher. Household Debt. *Chicago Fed Letter*, November 1997. Table 5.

However, it could be argued that even a small increase in the debt burden might have a significant impact on households with low incomes, which lack savings and other financial resources to weather economic adversity. Is there a straw that has broken the camel's back? While the median debt burden has grown for low-income families, have they gained greater access to credit cards? The next section takes up this question, by returning to the issues of growth and competition in the credit card industry.

Competition and Access to Credit Cards

To the casual observer, that is, to anyone with a mailbox or a television set, it appears that credit card issuers compete rather vigorously. If competition is not based on price, what form does it take?

In 1995 and 1996, returns on the credit card operations of banks were negative. In 1997, the bad news continued; there is now talk of a general retrenchment in the industry.²⁰ This development is not out of accord with economic theory, which predicts that in a free market, excess profits will be competed away. (Lending markets in the United States have in any case been prone to boom-and-bust cycles.) How did this happen during a period when the rates charged to borrowers held steady and when an important component of lenders' costs (the cost of funds to banks, reflected by the general level of interest rates) had fallen and remained low? A possible explanation is that competition among credit card lenders took the path of lowering credit standards.

²⁰Anderson, Tom, et al. Who Will Survive the Bank Card Shakeout? *ABA Banking Journal*, v. 89, November/December 1997. P. 55-64.

The question of credit standards is directly related to the bankruptcy reform issue. If banks, in search of profits, have voluntarily assumed higher credit risk by lending to those whom they would previously have deemed unacceptable risks, their contention that lenient bankruptcy laws are to blame for rising loan losses invites skepticism.

That credit card borrowing is now more widely available would seem self-evident to the casual observer introduced above, deluged everyday by unsolicited offers of credit. In addition, the shift of commercial banks' lending business from big corporations to small households has been one of the clearest trends in 20th century finance.²¹ But an expansion of credit card lending — which has certainly occurred²² — does not necessarily indicate a decline in credit standards. Available data, however, do shed some light on the recent evolution of the credit card market.

Data from the Federal Reserve's *Survey of Consumer Finances* on the percentage of families reporting credit card debt and the median dollar value of such debt are presented in table 5. Ausubel's research discussed above suggests that credit card debt may be significantly underreported by survey respondents, but there is no reason to think that the degree of such "wishful thinking" by consumers should have changed markedly between 1989 and 1995. In other words, the figures ought to give a roughly accurate picture of the *change* in the incidence of credit card debt even if they understate the true percentage of households that carry such debt.

The first set of figures in table 5 shows a steady increase in the percentage of families with credit card debt (not the same as families with credit cards). Looking at the breakdown by family income, the rate of increase is inversely related to the level of income. The proportion of low-income families with credit card debt has increased substantially; that of high-income families has grown less or, in the case of families at the top of the income scale, has shown no consistent pattern of growth. This may be attributed to several factors. High-income families were probably more likely to have had credit card debt before 1989, so there was less room for growth. In addition, some families in the upper income brackets may have substituted home equity loans (where rates are lower and interest is tax deductible) for credit card borrowing.

Nonetheless, the more rapid growth in the incidence of credit card debt among lower-income families does suggest a policy of extending credit to households who previously were denied access. It is interesting that for families with incomes below \$10,000, the incidence of debt grew rapidly between 1989 and 1992, but much more slowly between 1992 and 1995. This pattern suggests a typical lending cycle, in which the volume of loans expands until credit quality deteriorates, whereupon credit

²¹See, e.g., Ogden Nash on pre-war consumer lending, where the guiding precept was that money must never be lent to anyone who actually needs it: "Yes, if they request fifty dollars to pay for a baby you must look at them like Tarzan looking at an uppity ape in the jungle, And tell them what do they think a bank is, anyhow, they better go get the money from their wife's aunt or uncle." (From *Bankers Are Just Like Anybody Else, Except Richer*)

²²Outstanding credit card loans by commercial banks grew from \$52.5 billion in 1984 to \$217.3 billion in 1996, an increase of 314%, while total loans grew by 86%. (Source: FDIC.)

Table 5. Family Credit Card Debt, 1989-1995

Percentage of Families Reporting Credit Card Debt			
Income	1989	1992	1995
All Families	39.9	43.8	47.8
< \$10,000	13.4	23.3	25.4
\$10-24,999	29.1	39.7	41.9
\$25-49,999	53.1	55.8	56.7
\$50-99,999	59.0	51.3	62.8
> \$100,000	40.1	34.0	37.0
Median Value of Family Credit Card Debt (Thousands of 1995 Dollars)			
Income	1989	1992	1995
All Families	1.2	1.1	1.5
< \$10,000	0.4	0.5	0.6
\$10-24,999	0.8	0.9	1.2
\$25-49,999	1.1	1.2	1.4
\$50-99,999	1.8	1.6	2.2
> \$100,000	2.4	2.7	3.0

Source: Federal Reserve. *Survey of Consumer Finances*. Various Years.

standards are tightened. Banks' recent losses from credit card operations suggest that such a loan cycle may have peaked in the credit card market in the early 1990s.²³

The second set of figures in table 5 shows the median value of family credit card debt. These figures tell a different story: median credit card debt has increased among all families, but the increase has not been dramatic, which is what would be expected from the figures on the debt burden arising from credit cards (see table 4 on page 13). This pattern of moderate growth in aggregate credit card balances, without striking variation by family income, suggests that the growth in total credit card debt outstanding is not primarily a result of expanded access to credit among

²³On credit tightening, see: Zandi, Mark. The Lender of First and Last Resort. *Journal of Lending and Credit Risk Management*, v. 80, September 1997. P. 14-20.

lower-income families. This is also the conclusion reached by a 1997 study by Peter Yoo of the Federal Reserve Bank of St. Louis:

Increases in credit card debt are largely attributable to increased average credit card debt per household, not from more households with access to credit cards. Moreover, households in the top half of the income distribution account for most of the growth of credit card debt, even though lower-income households increased their access to credit cards and their average debt at a faster rate than the total population. So most of the increase in credit card debt between 1983 and 1992 is attributable to households with previous credit card experience and with above-average incomes, not to inexperienced, low-income households.²⁴

Returning to the issue of bankruptcy reform, the data in table 5 do not show that lowering credit standards to accommodate low-income (and, other things being equal, high-risk) borrowers is mainly responsible for the growth in credit card loan volume. There may have been a general loosening of credit standards, consistent with the cyclical nature of most lending operations, but there is no obvious evidence that low-income, financially unsophisticated households were the special beneficiaries (or victims). These observations provide little support for the contention of anti-reform groups that irresponsible, greedy, and reckless lending policies have led to record bankruptcies.

Summary of Data and Conclusion

The data considered thus far — the available data — do not provide any direct way to assess the impact of credit card lending on the rise in personal bankruptcy that began in the early 1980s. We have seen that the incidence of credit card debt has increased significantly among lower-income families, and that the aggregate debt burden of such families has risen simultaneously. However, credit card debt does not appear to have played a leading role in the growing debt burden of these families. The data do not show that the median family credit card debt, either as a dollar figure or as the percentage of family income that debt service requires, has reached a level that justifies alarm. Credit card debt, despite an impressive rate of growth over the past decade, remains a small percentage of household debt, and the families with the greatest amount of debt outstanding are those with the highest incomes and, consequently, the greatest ability to repay.

Still, personal bankruptcies continue to soar. The conclusion must be that analyses based on aggregate, average, or median statistics are of limited value in identifying the causes of personal bankruptcy. As a group, bankruptcy petitioners must be unrepresentative in their levels of debt or in their debt/income ratios. This is no surprise, despite claims that the stigma of filing bankruptcy has declined. Only scattered and fragmentary information about the financial condition of bankruptcy petitioners is available. For example, a 1996 VISA study reported that bankcard

²⁴Yoo, Peter S. Charging up a Mountain of Debt: Accounting for the Growth of Credit Card Debt. *Federal Reserve Bank of St. Louis Review*, v. 79, March/April 1997. P. 13. (This study was done before the 1995 *Survey of Consumer Finances* was released.)

losses due to bankruptcy in 1995 amounted to \$4.7 billion, or an average of \$5,400 per nonbusiness bankruptcy.²⁵ This figure is considerably higher than the median figures reported in the Survey of Consumer Finances, but it is not so large as to suggest that it dominates the petitioners' balance sheets. Without information on petitioners' other liabilities, together with their assets and incomes, the credit card figure lacks context and meaning. (The bulk of the VISA study is a survey asking the reasons why people filed for bankruptcy. The most common response was "overextended," which only begs the question that most interests policy-makers and economists: why are so many consumers overextended when the economy appears to be doing so well?)

Is credit card borrowing a trap for the unwary, bringing disorder into the financial houses of an unspecifiable number of atypical families and individuals? Perhaps, but so are medical expenses, divorce, job loss, casino gambling, narcotics, investment scams, and so on. Anecdotal evidence abounds, statistical evidence is scarce. The difficulty in considering bankruptcy reform proposals lies in the need to make decisions about general trends without knowing the particulars.

²⁵Consumer Bankruptcy: Consumer Debtor Survey. *In*: U.S. Congress. House. Committee on Banking and Financial Services. *Consumer Debt*. Hearing, 104th Congress, 2nd session, September 12, 1996. (Serial No. 104-74) p. 437.