Opportunistic Borrowing in the Credit Card Market

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Opportunistic/Strategic Borrowing

- Do borrowers strategically "run up the tab" before debt is charged off?
  - Evidence of increased nonpayment for goods/services before filing for bankruptcy (Argyle, Iverson, Nadauld, and Palmer, 2021)
  - **Welfare significance:** such behavior increases creditor losses → deters lending
  - **This paper:** what about credit cards before charge offs?

- People make mistakes when repaying debt
  - E.g., Andersen et al. (2020), Gathergood et al. (2019)
  - **This paper:** do they also make mistakes when defaulting?

Key Results

- **Empirical strategy in a nutshell:** compare credit cards (CCs) for the…
  - **Same borrower** in the **same month**…
  - After **multiple cards go delinquent** (missed payments)…
  - That **differ** in whether the card is **eventually charged off**

- **Ask:** use more of the available credit on the eventually charged off card?
  - If **Pr(charge off) = 100%** and **cost of default doesn't vary with debt** ,they should use 100% of charged off card before charge off

- **Results:** no! Future charge-off doesn't predict Cov(borrowing, avail. credit)
  - HHs do not appear to perfectly anticipate charge offs and/or anticipate high def. costs

Comment 1:
Forecasting Charge Offs

Information frictions could curb strategic borrowing

- **Which** card will be charged off may be **hard to forecast**
  - Lender has **discretion over whether and when** to do so
  - Lenders can also opt to **modify loans** ("payment arrangement", link)
  - Borrowers need not be "delusional about keeping the doomed cards alive"

- Authors can predict charge off with R2 of 32%
  - But they have a lot more data/information than borrowers!

- It's still important to know whether consumers strategically borrow
  - Evidence on whether it's because they can't or won't would sharpen implications
  - **Non-trivial (but potentially useful) suggestion:** survey to gauge borrow knowledge

Comment 2:
Plausibility of High Default Costs

Are default costs high enough to deter strategic borrowing?

- Default is costly, but how costly is a *marginal* dollar of defaulted debt?
  - Paper argues not very (hence, infer large non-pecuniary costs or biased beliefs)
  - More debt at charge off doesn't predict *worse* credit score, limit, or APR effects

- Large psychological (non-pecuniary) costs are plausible:
  - Credit card delinquency: Bursztyn et al. (2019)
  - Bankruptcy: Indarte (2023)

- But it's worth considering other costs of strategic borrowing may explain reluctance to default

UK creditor reactions to persistent debt & delinquency

What happens if I can't make my minimum payment?

Making regular payments means you'll avoid additional fees and charges, the risk of losing any promotional offers and any negative effect to your credit file, which is important if you want to apply for credit in future. Please also be aware that if you can't make your minimum payments, your card may be blocked.

MBNA Bank (https://www.mbna.co.uk/credit-cards/help-and-support/faqs/experiencing-difficulties.html)

4. What will credit card providers do when I've been in persistent debt for 36 months?

- If they have not already done so, your credit card provider will contact you to set out **options** for you to pay off the balance more quickly, usually within three to four years.
- Different card providers may have **different solutions**, which may for example include a paydown plan, or perhaps transferring the credit card balance onto a cheaper personal loan.
- There are some circumstances where your credit card provider may decide to **suspend your credit card**. They will let you know if they need to do this. See also Question 7.
- Some credit card providers may also decide to set the minimum payment at a higher level to help you to repay more quickly and so save you money in interest. If they plan to do this, they will write to you to explain, including what you need to do if you can't afford the higher amount.

Discussion of FCRA persistent debt rules (https://www.ukfinance.org.uk/our-expertise/cards/financial-conduct-authority-fca-rules-persistent-credit-card-debt-36-months-actions-frequently)

Other costs of strategic borrowing

- Strategic borrowing may increase…
  1. Creditor reluctance to agree to modification
  2. Creditor speed/desire to pursue a charge off
  3. Probability creditor freezes account

- Wrt 2: Table 8 shows balances predict charge offs
  - (variables need to be standardized to interpret how strong of a predictor)

- **2-3 could be disciplined by data and incorporated into model**
  - Pr(charge off) depends on delinquency duration in model, not directly on balances

Implications for ability to test for strategic borrowing

- Freezing delinquent (or persistent debt) cards may prevent strategic borrowing
  - This makes it harder to test whether borrowers *want* to strategically borrow
- Paper: 20-45% of cards have zero *net borrowing* when delinquent
  - Table 5 excludes these cards (and still finds no strategic borrowing)
- **Q:** how many have zero *spending*?
  - That'll give an upper bound for % frozen
  - Spending (not net borrowing) needed to tag non-delinquent frozen cards

Comment 3:
Model

When is it optimal to max out your CC?

- Model has a **bang-bang solution**: spend 0% or 100% of available credit

- This is **not a generic feature of consumption-saving models**
  - Typically, you get a distribution of wealth in such models
  - Not everyone bunching at either 0% or 100% of their borrowing constraint(s)

- How does strategic borrowing look in a standard model?
  - A higher probability of default, all else equal, lowers the *effective* cost of borrowing
  - Changes in Pr(charge off) should **move borrowing along the demand curve**, but not generally in a "bang-bang" way

Allowing Repayment

- In model: borrowers lack discretion to choose how much to repay
- Either pay minimum (interest + exogenous $\pi\%$ of debt) or nothing
- Borrowers face a constraint limiting paying down of debts
  - Inability to repay debt as quickly as agents would like makes it more costly to service
  - Delinquency and default become more appealing in this environment
  - **This misspecification influences the measured default costs → can bias upwards implied default costs needed to rationalize reluctance to default**
- **Suggestion:** let households to choose any feasible debt *level* (i.,e., $\in [0, \text{limit}]$)

In conclusion...

Conclusion

- Very interesting paper!
- Rich credit card data
- Important but understudied question: do consumers strategically borrow in anticipation of default?
- Enriching the model is a promising direction to improve ability to learn about borrowers' perceived default costs