The Economic Consequences of Bankruptcy Reform

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Overview

- **Question:** how did BAPCPA affect filing and credit card rates?

- **Findings:**
  - ▸ Excess mass approach: filing fell 50%
  - ▸ Compare FICO bins: 1pp decline in filing $\Rightarrow$ 67 bp rate decline (infer 60-75% pass-thru)
  - ▸ Change in effect of hospitalization on filing: fell from 1.5% to 0.4%

- Generous bankruptcy $\uparrow$ insurance, but can $\uparrow$ moral hazard and $\downarrow$ credit access
  - ▸ Scale of trade-offs suggests getting policy right is valuable
  - ▸ Interest rate response key determinant of optimal exemption design (Dávila, 2020)
  - ▸ Limited pass-through reduces credit access benefits of harsh bankruptcy

- **Comments:** interpretation, and can we conclude pass-through is high?

Other Costs of Bankruptcy

- What other costs outside of *immediate monetary* costs could influence filing?

- **Stigma:** moral aversion to default (typically modeled as disutility penalty)
  - ► 82% households say default is morally wrong when able to pay (Guiso, Sapienza, and Zingales, 2013)
  - ► Default deterred by threat of disclosure to friends/family (Diep-Nguyen and Dang, 2019)

- **Dynamic costs:**
  - ► **Credit market exclusion**
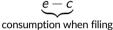   (Musto, 2004; Dobbie, Keys, and Mahoney, 2017; Albanesi and Nosal, 2020)
  - ► **Labor market exclusion**
    (Bos, Breza, and Liberman, 2018; Dobbie and Song, 2015)

Comment 1: "Other" Costs Important for Rate Pass-Through

Model omits non-monetary costs such as stigma

- GKLNW Model – filing threshold characterized by indifference condition:

$$\underbrace{y^\star - (1+r)b}_{\text{consumption when not filing}} \qquad = \qquad \underbrace{e - c}_{\text{consumption when filing}}$$

- Probability of filing $= p = F(y^\star)$, direct effect of change in cost of filing:

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  - ▸ $\frac{u'(c^B)}{u'(c^{N\star})} \approx 1/4$ (estimate from Indarte, 2019)

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$$u(\ \underbrace{y^\star - (1+r)b + b'}_{\text{consumption when not filing}}\ ) + \mathbb{E}(V'|\text{repay}) = u(\ \underbrace{e - c}_{\text{consumption when filing}}\ ) + \mathbb{E}(V'|\text{file})$$

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- Expression for pass-through in perfect competition benchmark changes:

$$\frac{dr}{dp} = \frac{(c + \Delta C)/b}{(1 - p)}$$

  where ΔC is the marginal filer's increase in consumption upon filing

- Omitting the ΔC term *understates* pass-through in perfect comp. benchmark

- With "too small" benchmark, comparing GKLNW estimates *overstates* pass-through %

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- GKLNW equation characterizing lender recoveries:

$$R(r) \equiv \underbrace{\int_0^{y^\star} \max\{0, y - e\} \, df(y)}_{\text{recovered from filers}} + \underbrace{\int_{y^\star}^{\infty} (1 + r)b \, df(y)}_{\text{recovered from non-filers}}$$

where $y^\star = e + (1 + r)b - c$

- Here, c only indirectly affects recoveries by changing the threshold

- Note: in contrast, exemption amount e affects the threshold and amount recovered

- GKLNW expression for pass-through of changes in e: $\frac{c + [F(y^\star) - F(e)]/f(y^\star)}{b(1-p)} > \frac{c}{b(1-p)}$

Comment 2: Perfect Competition Benchmark Calibration Challenges

a. Monetary cost term in pass-through equation is not a cost received by creditors

b. **BAPCPA affected monetary costs both received and not received by creditors**

BAPCPA Component	Filer → Creditor	Filer Only
Means test	Limited Ch. 7 access (\$Ch. 13 $\geqslant$ \$Ch. 7)	
Fraud rules	Limited CC debt eligible for discharge	
Counseling, doc. rules	Delay filing, garnish wages longer (White, 2007)	Hassle costs
Raised court fees		Higher court fees
↑ Lawyer liability		Higher legal fees

$\Rightarrow$ total effect of BAPCPA worked through both types of costs, not just c

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b. BAPCPA affected monetary costs both received and not received by creditors

c. **Pass-through is larger for a given change in costs when received by creditors**
   - Benchmark used in paper understates pass-through in perfect competition
   - Comparison with estimated effect overstates pass-through %

Comment 3: Was Info Revelation Part of the Treatment? (Exclusion Restriction)

- Pre-announcement of BAPCPA gave opportunity for "rush-to-file"

- An excess of almost a year's worth of filing occurred in this intermediate period!

- ↑ info: many more people revealed they're "bad" types (from perspective of creditors)

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- **Test:** did the gap in credit access *widen* for non-filers vs. recent filers?
  - Having not filed recently should send a stronger (positive) signal ⇒ wider gap
  - If unable to see filing history in Mintel, could compare Δ in counties with high/low rates

Conclusion

- Analyzes key trade-offs of 2005 Bankruptcy overhaul
  - Costlier bankruptcy lowers interest rates but also erodes insurance value
  - Rich data and clean estimates of important effects of bankruptcy policy

- Empirical approach is hybrid of "treatment-intensity" DID and DID-IV
  - Could adapt to other settings where events/policies affect groups heterogeneously
  - Excess mass approach also nice econometric solution to anticipated events

- Model could be brought closer to reality with non-monetary and dynamic costs
  - Add'l challenges arise when using model to draw inferences on credit market competition
  - Recommendation: use Indarte (2019) model for filing decision, use comparative statics to highlight channel through which policy affects rates

- Important and fascinating paper!