What Limits Take Up of Household Debt Relief?

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Household Debt Relief, New data, Micro-Macro Perspectives
Swedish House of Finance
Keynote

Households Forgo Valuable Debt Relief Opportunities

- 0.5 – 1 million US households receive debt relief in bankruptcy each year
  - 10-20x more would increase their net worth from filing (Antill Jenke Kluender, 2024)
- Take up of emergency debt relief during COVID was imperfect
  - 1/3 of homeowners in mortgage forbearance missed no payments (JPMCI, 2020)
  - Only 3/4 non-performing *eligible* GSE loans entered forbearance (Kim et al., 2022)
- 20-60% of US student loan borrowers in income-driven repayment failed to recertify their income in time to continue receiving relief (Pew, 2022)

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Why do households fail to take advantage of debt relief programs?

State of Knowledge

- There is a lot more work to be done to understand the use of debt relief

- In particular, we would benefit from studies of different...
  - Barriers to access/take-up
  - Forms of debt relief (including the extent of “missing” take-up)
  - Types of moral hazard related to take-up (ex ante and ex post)
  - Institutional and cultural settings

- **This talk:** summarize key findings and promising directions for new work

Agenda

[Background: Types of Debt Relief]

[Theory: The Debt Relief Take-Up Decision]

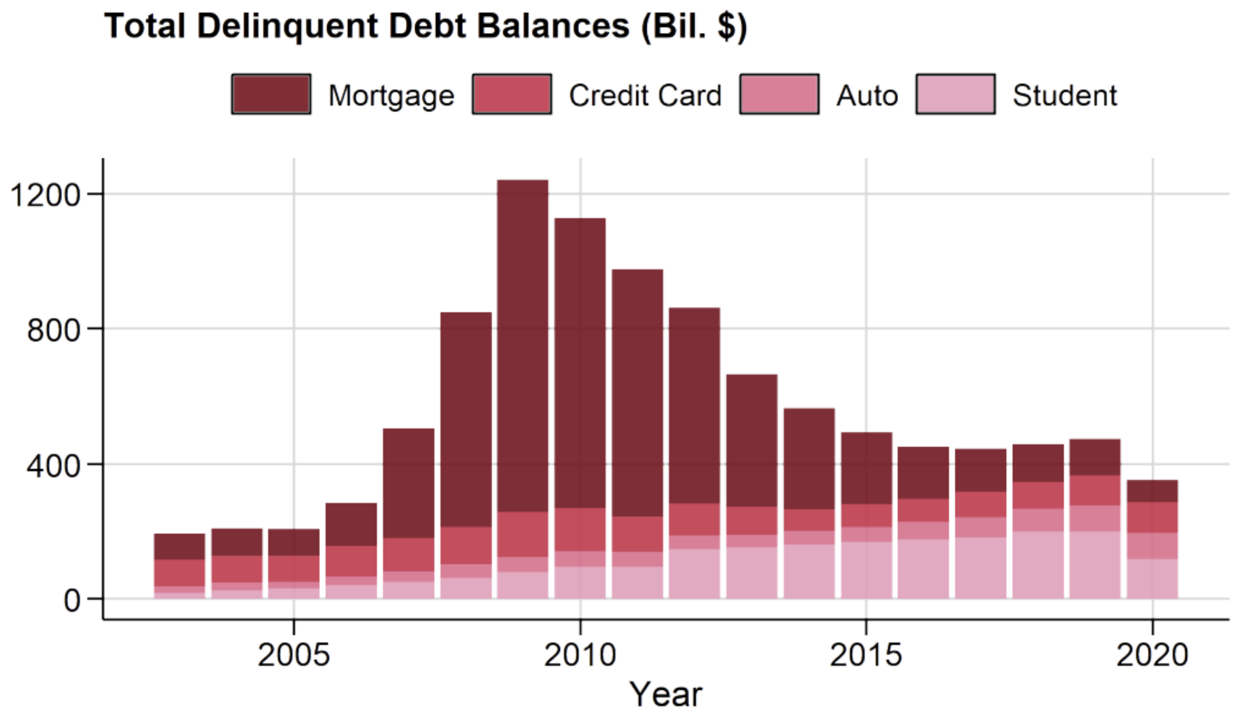
[Empirics: Evidence on Barriers to Debt Relief]

Background:
Types of Debt Relief

Type 1/3: Default

- *De jure* default: accessed via formal policy process (e.g., bankruptcy)

- *De facto* default: delinquency/nonpayment



Source: FRB-NY Consumer Credit Panel, in Indarte (2022)

Type 2/3: Private Modifications

- **Credit Counseling**
  - Non-profits that undertake a multi-lateral negotiation with creditors to obtain a modified sequence of payment (a “debt management plan” or “DMP”)
  - In 2011, 1.6 million US borrowers used a DMP to repay $1.5-2.5 billion in credit card debt (Wilshusen, 2011)

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  - For-profits that bilaterally and sequentially negotiate for debt balance reductions
  - Settled $6 billion of US consumer debts in 2019 (Gibbs et al., 2020)
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- **Non-Intermediated Settlements:** direct negotiation with lenders
  - Settlements on *exacerbate* financial distress: recipients have 20% and 160% higher risks of future delinquency and bankruptcy (Cheng et al., 2021)

3/3: Public Modifications

- Often related to crises
  - HAMP modified mortgages for 1.8 million US household experiencing financial hardship in the Great Recession (Ganong Noel, 2020)
  - CARES Act: 60 million US residents had $1.1 trillion mortgage debt and $580 billion student loans enter forbearance (Cherry et al., 2021)

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- In developing economies, debt forbearance and forgiveness programs are often associated with the electoral cycle (Cole, 2009; Breza, 2012; Breza Kinnan, 2021)
  - In developing economies, a substantial amount of household debt, that is also targeted by relief efforts, is owed to non-financial institutions, such as utilities companies (Indarte Kanz, 2024)

Theory:
The Debt Relief Take-Up Decision

Environment (based on Indarte 2022, 2023)

- A household chooses whether to repay or take debt relief
- When repaying, her consumption is $C^R = A + Y - D$
  - Where $A =$ non-seizable assets

    $Y =$ assets seizable in excess of amount E

    $D =$ debt payment owed
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- The household takes debt relief when $u(A + E) - \sigma > u(A + Y - D)$

Moral Hazard and Liquidity Effects

- Decision to take debt relief follows a threshold-style rule: take if $Y < Y^\star$
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- Causal effect of debt payment size on default isn't pure moral hazard

Inferring costs and insurance value from behavior

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- Implications of a stronger liquidity effect $\left(\frac{-\partial p/\partial A}{\partial p/\partial E} \gg 1\right)$:
  - Marginal taker's consumption gain is large: $C^D > C^{R\star}$ → higher insurance value
  - But other costs of filing (dynamic, stigma, etc.) must be large

$$u\left(C^D\right) - \sigma = u(C^{R\star})$$

Application: Personal Bankruptcy in the US (Indarte, 2023)

- Exploit two natural experiments to estimate **moral hazard** and **liquidity** effects for personal bankruptcy

- Find small moral hazard: $1,000 ↑ relief generosity → 0.02 pp filing

Figure 2: The Effect of Seizable Equity on Bankruptcy Filings

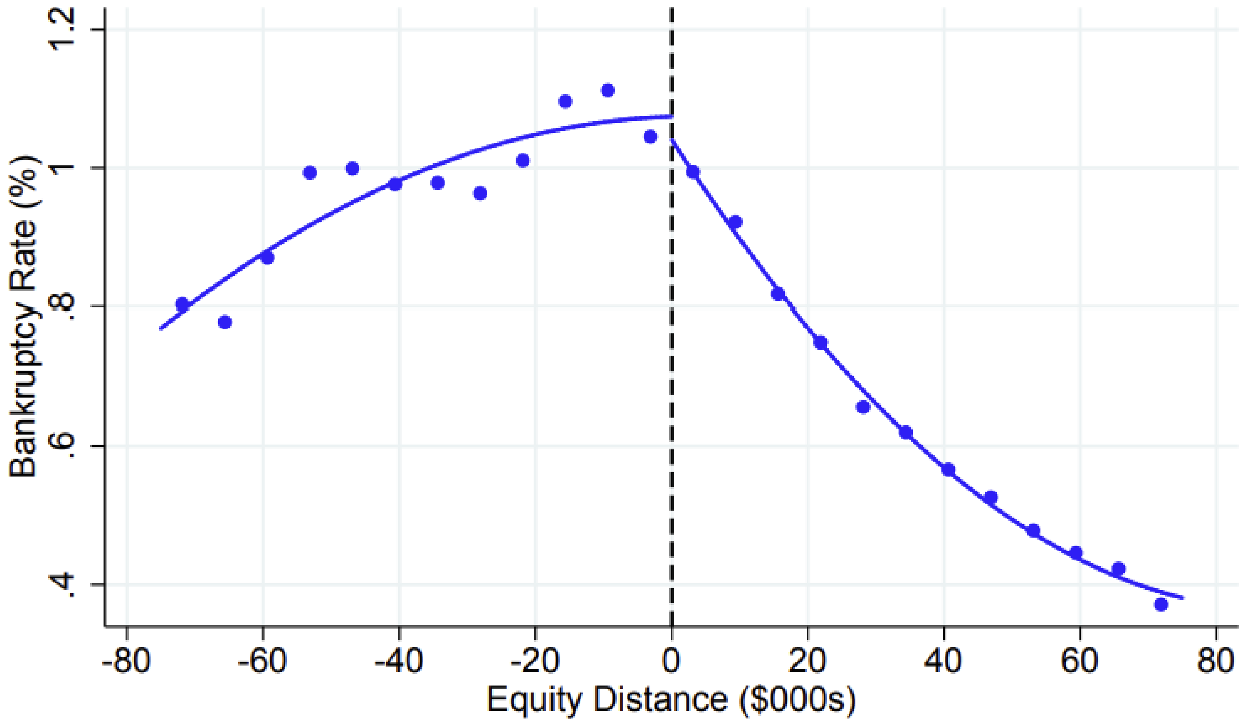

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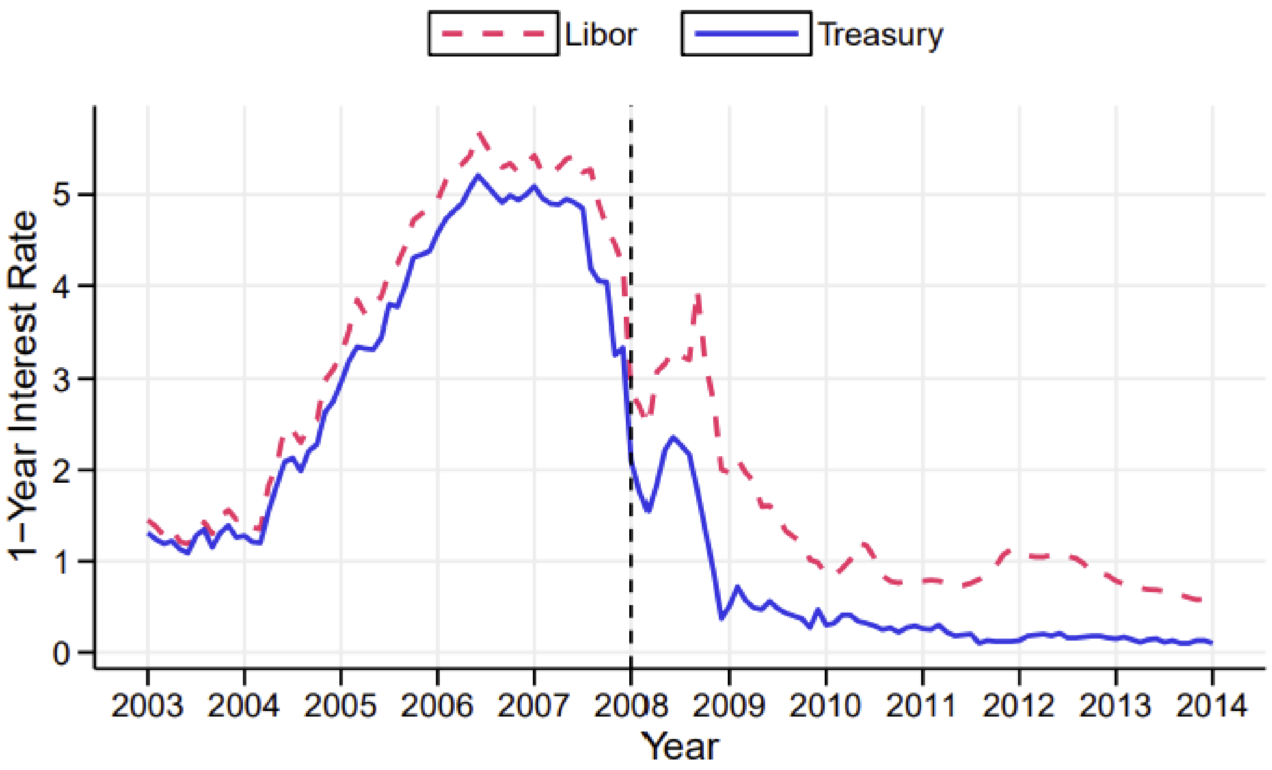
Figure 3: One-Year Libor and Treasury Rates



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Implied insurance value is large!

Corresponds to **58.4% of consumption** for marginal filer

But this also implies large dynamic or non-pecuniary costs… (i.e., large deterrents to filing)

Empirics:
Evidence on Barriers to Debt Relief

Typology of Barriers to Debt Relief

- Demand factors
  - Frictions & financial costs
  - Imperfect information
  - Preferences

- Supply factors
  - Bias
  - Technology
  - Policy

Demand: Frictions and Financial Costs

- Financial costs
  - De jure default generally entails large fees; $1-2k for bankruptcy, typically
  - Receiving tax rebates led to an **increase** in Ch 7 bankruptcy (Gross et al., 2014)

- Credit and labor market costs
  - Bankruptcy flags limit credit access and (sometimes) employment opportunities (Musto, 2004; Dobbie et al., 2017; Dobbie et al., 2020; Bos et al., 2018)
  - But **marginal** bankruptcy recipient has **better credit access and labor market** outcomes after receiving debt relief (Albanesi Nosel, 2022; Dobbie Song, 2015)

Demand: Imperfect Information

- 34.8% of eligible mortgage borrowers that didn't take forbearance for reasons other than not needing it didn't apply because of a lack of understanding of eligibility rules and/or how it worked (Lambie-Hanson et al., 2021)

- Filing increases when co-workers have successful bankruptcy petitions (Kleiner et al., 2021)

- In progress: bankruptcy info intervention (Antill Jenke Kluender, 2024):
  - "Filer success" treatment: "7% of Ch 7 filers surrender assets and 96% receive relief)
  - "Credit access" treatment: "average credit score increases 80 points after filing"
  - Will document pre-treatment bankruptcy knowledge and propensity to file

Demand: Preferences

- Social norms may **stigmatize** use of debt relief
- 82% of US households say it's morally wrong to default when able to pay (Guiso et al., 2013)
- Moralizing messages from creditors can reduce credit card delinquency (Bursztyn et al., 2019)
- Disclosing non-payment to friends/family can reduce delinquency (Diep-Nguyen Dang, 2020)

Supply: Bias (evidence from Argyle et al., 2024)

- Black Chapter 13 filers are 11.2 pp more likely to be denied debt relief
  - 2.2 pp more likely in Chapter 7

- When randomly assigned to a White trustee (key legal official), Black Ch 13 filers are **3 pp** more likely to be dismissed without debt relief
  - No such effect in Ch 7
  - We formalize and test assumptions for which this **homophily** indicates **bias**

- This **homophily** reduces with **trustee experience** and is partly accounted for by White trustees setting **higher required payments** on Ch 13 plans
  - Suggests bias may stem from (1) inaccurate beliefs and (2) financial incentives

Supply: Technology (evidence from Kim et al., 2024)

- Probability of eligible mortgages entering CARES Act forbearance varied 10% – 60% across servicers

- Which servicers had the most borrowers miss out on forbearance?
  - Smaller servicers
  - Nonbanks
  - Nonbanks with low cash holdings

- Older and low-credit score borrowers were less likely to enroll

Supply: What influences debt relief *policy*?

- Greater **moral hazard** limits policy gains from generous debt relief
  - Ex ante moral hazard: taking actions that make you more likely to take debt relief in the future (e.g., Argyle et al., 2021; Ebrahimian, 2023; Hampole, 2024)
  - Ex post moral hazard: willingness to take up debt relief given earlier choices (e.g., Indarte, 2023; De Silva, 2024)

- Hypothesis: **social norms** about debt and personal responsibility

- Debt relief can be a **substitute** for **social insurance**
  - Health insurance reduces use of bankruptcy (Gross Notowidigdo, 2011)
  - Generous bankruptcy reduces take-up of health insurance (Mahoney, 2015)

Debt & Health Insurance

Conclusion

Conclusion and next steps

- Households are leaving significant money on the table in the form of forgone debt relief

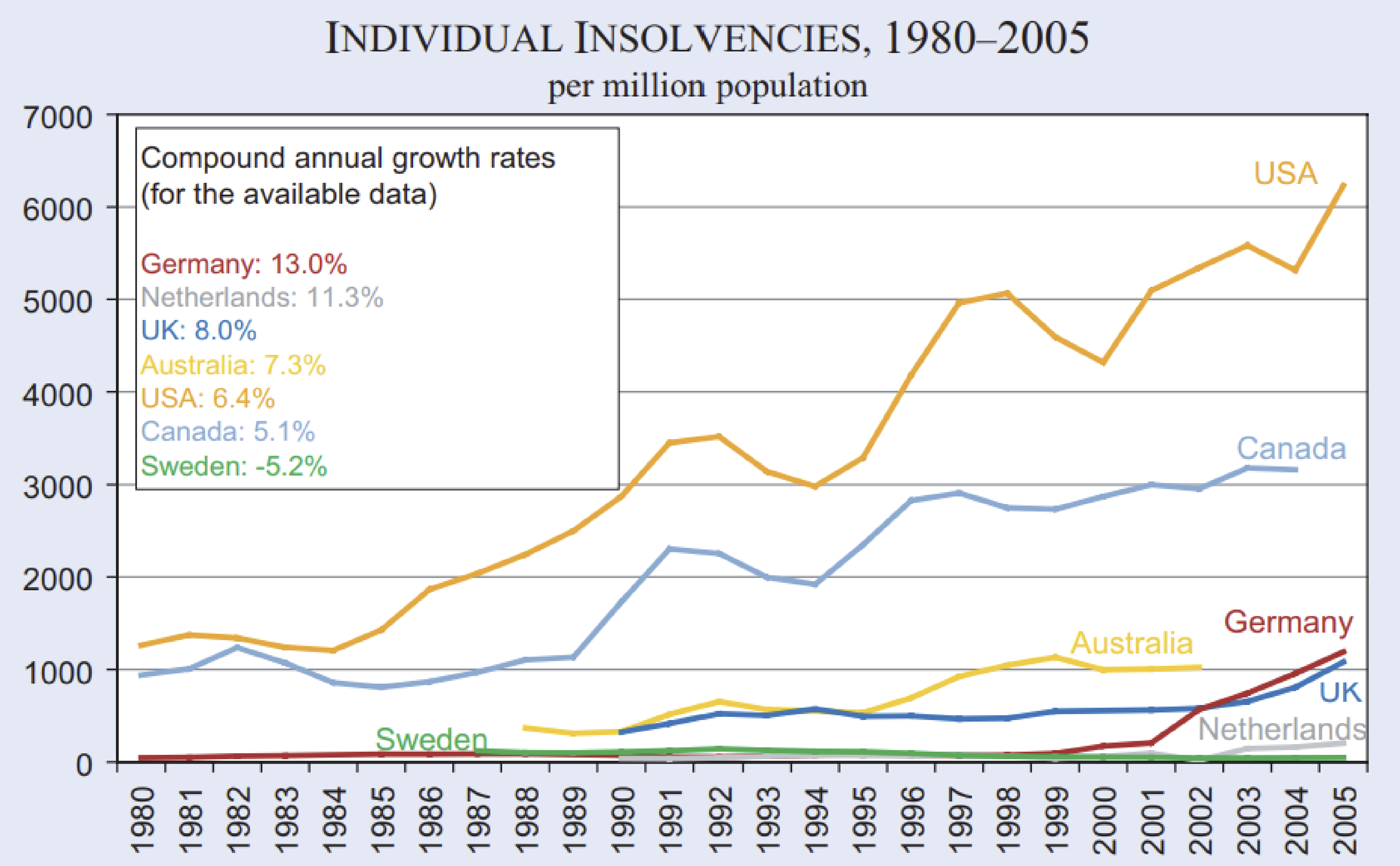
- Reasons likely vary with context
  - Type of debt relief, cultural setting, policy environment, etc.

- Knowing *why* households do this is important
  - E.g., generally efficient if due to preferences, but inefficient if due to lack of info

- Understanding what limits supply and demand for debt relief is crucial for optimal debt relief policy design

Appendix

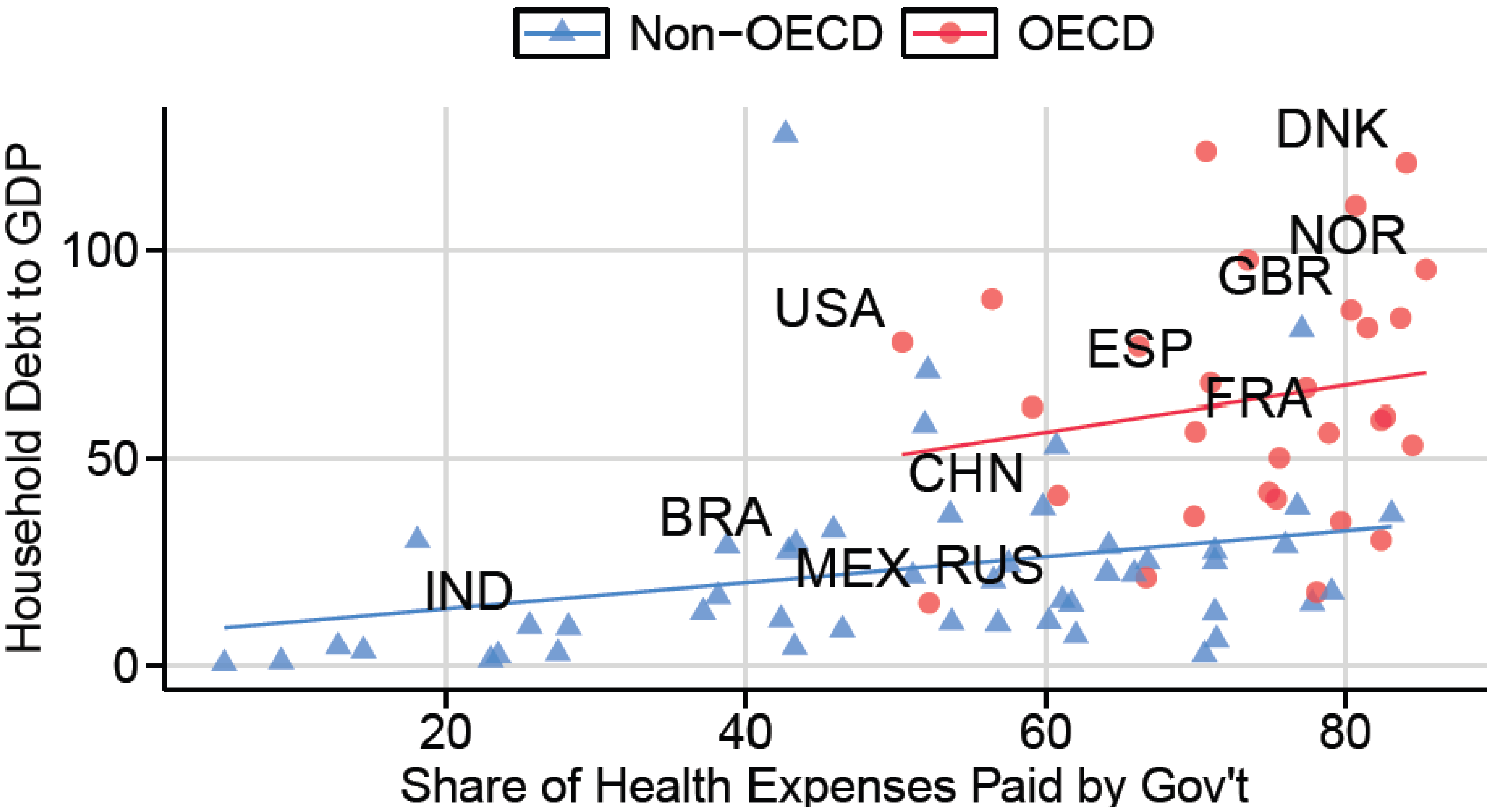
Bankruptcy-like debt relief is rare outside of US and Canada



Source: Osterkamp (2006)

Household Debt and Public Health Insurance

[back]



Source: IMF and WHO in Bornstein Indarte (2023)