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State bankruptcy laws and the responsiveness of credit card demand

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ABSTRACT

The responsiveness of credit demand to interest rate changes may vary widely by state due to differences in state bankruptcy and insolvency laws. Bankruptcy exemptions and other state laws insulate borrowers against negative consequences from non-repayment, and so lenient regulations may lead to decreased responsiveness to interest rate increases. Lenient laws also decrease creditors' incentive to lend, and a resulting decrease in loan options will reinforce the inelasticity of credit demand. This paper presents a model that predicts (1) that credit demand is less responsive in states with borrower-friendly, lenient bankruptcy and insolvency laws, and (2) the effects of state laws on demand elasticity will be strongest among borrowers facing credit constraints. Using market experiment data from a large credit card issuer, this paper presents evidence that supports the hypothesis that demand responsiveness and insolvency law leniency are negatively related. Borrowers are more likely to continue using a card in states with lenient exemption and garnishment laws. Borrowers who take up less attractive offers are more likely to be credit constrained; among these borrowers, the impact of exemption laws is much stronger than among the unconstrained group.

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1. Introduction

There is a strong theoretical link between state-level insolvency laws and a borrower's willingness and ability to borrow. State laws not only determine what a borrower submits to creditors in bankruptcy proceedings, but also largely regulate what goods and what proportion of a borrower's income can be seized when the borrower defaults but does not file for bankruptcy. A borrower's cost of debt is lower in states where he bears a lower burden in default. Similarly, a creditor's cost of lending is higher in states with borrower-friendly insolvency laws.

This paper presents a model that predicts that credit card borrowers living in states with lenient insolvency laws will be less responsive to differences in interest rates. The reasons for the lack of interest rate sensitivity are twofold. First, borrowers in these states are more likely to default, and a borrower with a high probability of default will be less responsive to interest rates because he is less likely to pay the full interest owed. Second, the supply of credit will contract in these states due to higher expected default rates, leaving borrowers with fewer alternatives[1]. The model predicts (1) the riskiness of the pool of borrowers who take up a new credit card offer will be a function of state insolvency laws, (2) borrowers in states with less costly default will be less likely to switch to a new card in response to an interest rate increase, and (3) the difference in demand responsiveness described in (2) will be larger for credit-constrained borrowers than for unconstrained borrowers.

The results reported in this article exploit variation in credit supply in a dataset with a quasi-experimental structure. The data was generated based on a series of "market experiments" conducted by a large credit card-issuing bank in the late 1990s. The bank created a mailing list of potential customers with credit histories that were within the range that qualified for pre-approved gold card offers, and these names were randomly assigned to market cells that varied by introductory offer. Individuals who took up the offers were tracked for 18–28 months. Because the bank did not base offers on state of residence, the data offers an opportunity to test whether state laws impact individuals' responsiveness to interest rates and whether the impact of state laws is stronger for individuals who face borrowing constraints.

The primary focus of this paper is the impact of insolvency laws on the probability that an account holder uses the card to borrow in a particular month. The results support the proposition that individuals living in states with lenient homestead exemptions are more likely to be active borrowers. Moreover, individuals who are willing to pay higher interest rates show decreased responsiveness to differences in state laws.

This paper fits into the substantial body of economic work that measures the impact of insolvency laws; the majority of this literature focuses on the impact of these laws on bankruptcy rates. Most insolvency laws fall into one of two major categories: exemption laws and collection laws. Exemption laws, which have federal- and state-level components but are effectively determined by states, specify the amount and value of property a borrower is allowed to keep in a Chapter 7 bankruptcy, the most common type of personal bankruptcy. Exemption laws also restrict the property that can be seized when a borrower has not filed for bankruptcy; hereinafter this article will refer to non-paying borrowers who do not file for bankruptcy as being in a state of "informal bankruptcy[2]." Borrowers who make this choice are subject to collection, which is governed by garnishment and harassment laws. The Fair Debt Collection Practices Act and other federal legislation places some limits on credit collection, and states have instituted a range of harassment laws that add additional restrictions. Most prominent among the various collection regulations are garnishment laws, which determine what percentage of a borrower's wage a creditor can collect directly from an employer. States can set any percentage below the federal maximum of 25%[3].

Researchers have not established a strong empirical link between lenient exemptions and high bankruptcy filing rates. White (1976) and Domowitz and Sartain (1999) show robust, significant positive effects of bankruptcy exemptions on filings, but the bulk of research (Peterson & Aoki, 1984;

[1] Calem and Mester (1995) and Calem, Gordy, and Mester (2006) showed that borrowers with high balances were less able to acquire new credit.

[2] See Dawsey and Ausubel (2013).

[3] See Table 1 for a summary of state garnishment and exemption laws during the relevant time frame.

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