

APPENDIX G-2.c

**Credit Card Defaults, Credit Card Profits,
and Bankruptcy (Prepared by Professor
Lawrence M. Ausubel)**

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Credit Card Defaults, Credit Card Profits, and Bankruptcy

by

Lawrence M. Ausubel*

Credit card defaults have become an increasingly conspicuous feature on the bankruptcy landscape. In 1996, bank credit card delinquencies exceeded 3.5 percent—the highest delinquency rate since 1973, when statistics were first collected.¹ Bank credit card chargeoffs also veered upward to 4.5 percent per year, exceeding all but the levels recorded during the years 1991–1992.² At the same time, personal bankruptcy filings reached a record high 290,111 in the quarter ending September 30, 1996—up thirty-one percent from the corresponding period one year earlier—and surpassed one million for the first year ever in 1996.³

Both credit card defaults and bankruptcies soared amid a generally healthy economy with relatively low unemployment⁴ and reasonable growth in gross domestic product.⁵ Wall Street analysts warned that the consumer balance sheet was heading toward a precipice which endangered the health of the banking system, if not the economic expansion generally.⁶

Bankruptcies and credit card debt have even achieved prominence in the national political debate. In the first 1996 presidential debate, Senator Robert Dole responded to his initial question on the economy by referring to the record bankruptcy rate:

*Professor of Economics, University of Maryland at College Park. Copyright 1997. All rights reserved. This Article is based on a paper presented by the author at the Seventieth Annual Meeting of the National Conference of Bankruptcy Judges, San Diego, California, October 16-19, 1996. I am grateful to Neal Batson, David Erne, Professor Jeffrey Morris, Kim Kowalewski, Elizabeth Laderman, and Donald Morgan for helpful comments, discussions and ideas. I also wish to thank the Administrative Office of the United States Courts, the American Bankers Association, and the Federal Deposit Insurance Corporation for data used in this Article. Further, I thank Yi-Feng Chia for excellent research assistance.

¹See *infra* Figures 1, 2 and 6, which plot the seasonally-adjusted proportion of credit card accounts with positive balances that were thirty days or more past due. The monthly data series was provided by the American Bankers Association's *Consumer Credit Delinquency Bulletin*, seasonally adjusted by the author, and averaged over the three months of each quarter.

²See *infra* Figures 1 and 3, which plot the seasonally-adjusted, annualized proportion of credit card outstanding balances that were written off by bank credit card issuers. The 1971–1990 chargeoff rate is taken from LAWRENCE M. AUSUBEL, *THE CREDIT CARD MARKET, REVISITED*, tbl.1 (University of Maryland Department of Economics Working Paper, July 1995). The 1991–1996 chargeoff rate was provided to the author by the Federal Deposit Insurance Corporation, and was based on the Federal Financial Institutions Examination Council's quarterly Consolidated Reports of Condition and Income. The combined series was then seasonally adjusted by the author.

³See Administrative Office of the United States Courts, *Bankruptcy Filings Continue Upward Climb* (Dec. 9, 1996) <http://www.uscourts.gov/Press_Releases/bk396in.htm>. See also <ftp://bankrupt.com/Bankruptcy_Statistics>.

⁴The United States unemployment rate was 5.4 percent in 1996, as compared to an average of 6.5 percent over the previous four years and an average of 6.25 percent over the previous ten years. See generally 72 FED. RESERVE BULL. (1986) to 82 FED. RESERVE BULL. (1996).

⁵The growth rate in United States gross domestic product (in chained 1992 dollars) was 3.1 percent in 1996, as compared to an average of 2.7 percent over the previous four years and an average of 2.3 percent over the previous ten years. See *id.*

⁶For example, George M. Salem of Gerard Klauer Mattison & Co. in New York recently termed credit cards “the number-one risk in banking.” Gordon Matthews, Credit Card Delinquencies Worry Stock Analysts, *Am. Banker*, June 13, 1996, at 1. Analysts at Montgomery Securities in San Francisco noted that consumer loan losses now account for seventy-one percent of banks' total loan losses in 1996, up from twenty-seven percent four years earlier. *Id.*

Q: Senator Dole, the President said in his opening statement, “We are better off today than we were four years ago.” Do you agree?

A: Well, he’s better off than he was four years ago. . . . I look at the slowest growth in this century. He inherited a growth of 4.7, 4.8 percent; now it’s down to about 2.4 percent. We’re going to pass a million bankruptcies this year for the first time in history.⁷

Senator Dole followed up on this theme in the second 1996 presidential debate by linking bankruptcies with credit card debt, declaring: “[President Clinton] says we’ve had the best four years ever. That’s not true. We had over 1.2 million bankruptcies—set a new record. Credit card debt has never been higher.”⁸

Part I of this Article presents available data on credit card delinquencies and chargeoffs, and examines the relationship with data on the number of personal bankruptcy filings. The data reflect an historical increase in the rate of credit card defaults over the past twenty-five years, as well as a rise in personal bankruptcies in the 1990s which is astonishingly highly correlated with the rise in credit card defaults.

Part II reviews data relating credit card defaults and personal bankruptcy filings with two general economic factors: the cyclical state of the economy and the household debt burden. Credit card defaults and personal bankruptcy filings have exhibited a strong countercyclical component, moving upward in recessions and downward in economic booms, and have also tended to rise as the ratio of debt to disposable income has increased among American households. Part III analyzes the effect which credit card profitability has had on credit card defaults, arguing that the extranormal profitability of credit card lending has been an important factor contributing to the high current levels of delinquencies and chargeoffs. Parts IV and V discuss the effect which deregulation has had on credit card profits. The profit margins of credit card issuers substantially increased beginning in 1982, as a result of the functional deregulation of credit card interest rates coupled with prevalent consumer behavior. This has created incentives for card issuers to relax their credit standards, in turn leading to a secular increase in the rate of credit card defaults. Part VI explores the likely consequences of recent proposals to limit the dischargeability of credit card debt in bankruptcy. The Article concludes that various proposals for limiting the dischargeability of credit card debt are likely to lead to an increase in the expected profitability of lending to marginal consumers and to an increase in outstanding balances lent to marginal consumers. The predictable effect of further restricting the dischargeability of credit card debt is thus an increase, rather than a decrease, in the incidence of overextended consumers and an increase, rather than a decrease, in the already high rate of credit card delinquencies. Such a result, presumably, runs counter to the objectives of policymakers.

I. DEFAULTS AND BANKRUPTCY FILINGS

A. RISING LEVELS OF DELINQUENCIES AND CHARGEOFFS

Two broad measures of defaults by credit card customers have been consistently collected since the early 1970s. First, each quarter since the first quarter of 1973, the American Bankers Association has conducted

⁷ *Clinton-Dole Debate I: Full Text of the First Presidential Debate Between President Clinton and Republican Candidate Robert Dole in Hartford, Conn.*, WALL ST. J. INTERACTIVE ED. (Oct. 7, 1996) <<http://www.wsj.com>>.

⁸ *Clinton-Dole Debate II: Full Text of the Second Presidential Debate Between President Clinton and Republican Candidate Bob Dole in San Diego, Calif.*, WALL ST. J. INTERACTIVE ED. (Oct. 17, 1996) <<http://www.wsj.com>>.

a survey of over 500 banks nationwide in which the banks report the percentage of bank card accounts with positive outstanding balances that are past due thirty or more days at the end of each month. The Association regularly publishes these numbers in the *Consumer Credit Delinquency Bulletin*.⁹

Second, since the second quarter of 1971, Visa U.S.A., Inc. (Visa), the nation's largest bank card organization, has conducted a quarterly survey of its card-issuing member banks which asks for basic financial information related to their operations. The Visa survey gathers information regarding the major components of revenues and costs associated with bank card operations. Apparently, the survey does not confine its attention merely to the respondent banks' Visa operations; the survey response encompasses all credit card operations conducted by the banks, under any bank card name. One of the important pieces of information collected by the Visa survey is the credit card chargeoff rate: the percentage of outstanding balances which bank card issuers write off as uncollectible each year. Every quarter, Visa compiles the banks' responses and publishes (for members' use and comparison) systemwide figures for these financial numbers in the *Visa U.S.A., Inc. Profit Analysis Reports*. As might be expected, the results of the *Profit Analysis Reports* are not made available to the general public. However, during at least two critical junctures for the credit card industry, Visa and MasterCard, a second major player in the credit card market, have issued or commissioned reports (apparently intended to influence the legislative and regulatory processes) which disclose the Visa profitability data.¹⁰

FIGURE 1

Credit Card Delinquencies and Chargeoffs, 1971–1996

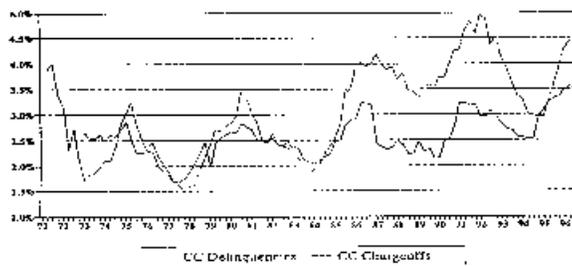


Figure 1 plots both of these principal data series, beginning with their inception in the early 1970s. The chargeoff-rate series is extended to the third quarter of 1996 by splicing the data for 1971–1991 with data for 1991–1996 from the Federal Deposit Insurance Corporation (FDIC) and making seasonal adjustments. The FDIC data is based on calculations from the *Consolidated Reports of Condition and Income*

⁹Throughout, this Article makes use of seasonally-adjusted versions of these numbers, always taking the arithmetic average of the rates for the three months within a quarter. See, e.g., 475 CONSUMER CREDIT DELINQUENCY BULL. (American Bankers Association), First Quarter 1996, at 5. The American Bankers Association also publishes a bank card delinquency figure based on *dollars outstanding* as opposed to the *number of accounts with outstanding balances*; however, the latter data series has apparently only been collected since the first quarter of 1981.

¹⁰In an earlier paper by this author, a technique known as “Reverse-Engineered”^J was utilized to obtain the quarterly Visa chargeoff data series from the second quarter 1971 through the second quarter 1991. See AUSUBEL, *supra* note 2, at 8. The chargeoff data series (and, later, the profitability data series) from the 1995 paper will be used throughout this Article. While this data does not perfectly match the *Profit Analysis Reports* data, the standard error arising from the reverse-engineering process can be computed to equal only 0.07 percent.

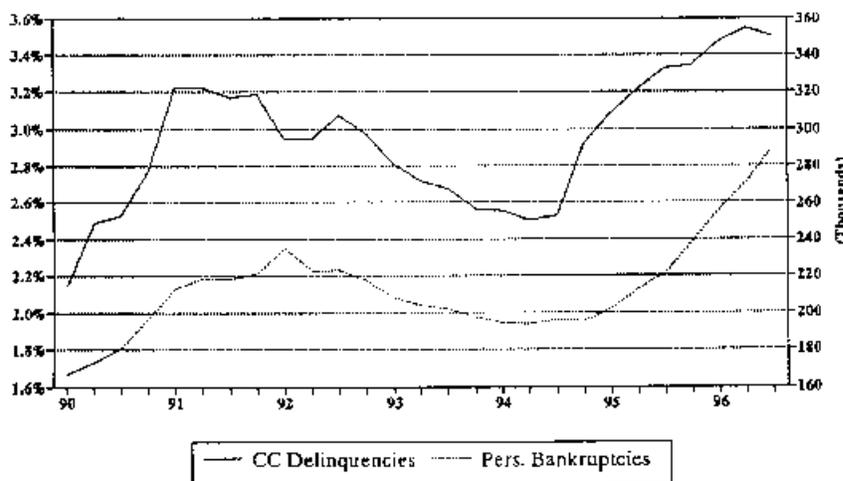
filed quarterly by all United States commercial banks with the Federal Financial Institutions Examination Council.¹¹

These two data series display two broad empirical regularities. First, credit card defaults fluctuate substantially with the business cycle. Second, credit card defaults have experienced a long-term secular increase. Delinquency rates, which exhibited cyclical peaks of about 2.75 percent in the pre-1982 period, now exhibit peaks of 3.25–3.5 percent or more. Chargeoffs, which exhibited cyclical peaks of about 3.5 percent per year in the pre-1982 period, now routinely exceed four percent even in nonrecessionary years. It is these empirical regularities which this Article seeks to explain.

B. BANKRUPTCY FILINGS RISE IN TANDEM

Figure 2 charts the total number of personal Chapter 7, 11 and 13 nonbusiness bankruptcy filings, on a quarterly basis, in the years 1990-1996, as compiled by the Administrative Office of the United States Courts, and couples that data with the data on credit card delinquencies reflected in Figure 1.¹²

FIGURE 2
Credit Card Delinquencies and Personal Bankruptcy Filings,
1990–1996



As seen in Figure 2, changes in the number of United States personal bankruptcy filings in the United States follow exceedingly closely changes in the rate of credit card delinquencies. As one might expect, changes in the rate of delinquency lead changes in the rate of bankruptcy by about one quarter. As

¹¹Since 1984, the Federal Financial Institutions Examination Council has collected and published disaggregated credit card chargeoff data for all United States commercial banks in the quarterly *Consolidated Reports of Condition and Income*.

¹²For example, in the quarter ending September 30, 1996, there were 198,540 nonbusiness filings under Chapter 7, another 91,292 under Chapter 13, and 279 under Chapter 11. See Admin. Office of the U.S. Courts, *Business and Non-Business Cases Commenced by Chapter of the Bankruptcy Code--By Quarter (1996)* [hereinafter AO Report] (on file with the Administrative Office of the United States Courts, Washington, D.C.). See also < ftp://bankrupt.com/Bankruptcy_Statistics/1980_to_1994_Statistics >. This quarterly data series was then seasonally adjusted by the author.

demonstrated by the data series depicted in Figure 2, the 1990s have seen an astonishingly tight relationship between credit card delinquencies and bankruptcy filings.¹³

II. DEFAULTS AND GENERAL ECONOMIC FACTORS

Revolving credit is now the single largest component of United States outstanding consumer credit, totaling \$435.7 billion at year-end 1995.¹⁴ By contrast, at the same year-end, automobile loans totaled \$354.1 billion and other consumer loans—such as personal loans, mobile home loans and education cards, \$123.9 billion was loaned on MasterCard, \$27.8 billion was loaned on Discover cards, \$9.7 billion was loaned on American Express cards, and most of the remainder was extended on retail store and oil company credit cards.¹⁵ Extrapolating from these figures, each American household now averages \$4,400 in credit card debt.¹⁶ Since this debt is unsecured, it is obvious that repayment will depend substantially on the cyclical state of the economy. When job loss or recession impairs a household's ability to repay its debts, the credit card borrowing is likely to be the first credit to go unpaid, perhaps followed soon thereafter by bankruptcy.

A. THE CYCLICAL NATURE OF CREDIT CARD DEFAULTS

Figures 3 and 4 provide graphic evidence of the cyclical nature of credit card defaults. Figure 3 displays the growth rate of the gross domestic product in the United States,¹⁸ along with the credit card chargeoff data series, quarterly, for the years 1971 through 1996.

¹³ The relationship between credit card defaults and bankruptcy filings was not especially close prior to the 1990s. This is hardly surprising, since in prior decades bank credit card debt was only a small portion of all consumer credit outstanding in the United States. At this writing, bank credit card debt is about one-third of all consumer credit; by contrast, in 1986, bank credit card debt was less than thirteen percent of all consumer credit, and in 1976, bank credit card debt was only five percent of all consumer credit. See FAULKNER & GRAY'S CARD INDUSTRY DIRECTORY, 1997 (1996) [hereinafter CARD INDUSTRY DIRECTORY]. At year-end 1995, bank credit card debt was \$358 billion. *Id.* At year-end 1986, bank credit card debt was \$82 billion, and was \$11.8 billion at year-end 1976. AUSUBEL, *supra* note 2, at tbl.2. Overall consumer credit was \$1,093 billion at year-end 1995, was \$637 billion at year-end 1986, and was \$222 billion at year-end 1976. See *generally* 62 FED. RESERVE BULL. (1976) to 81 FED. RESERVE BULL. (1995).

¹⁴ See *generally* 81 FED. RESERVE BULL. (1995).

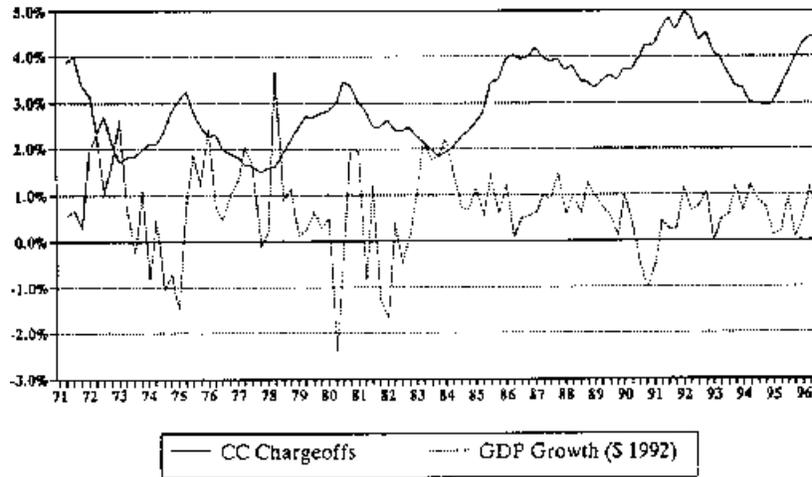
¹⁵ *Id.*

¹⁶ CARD INDUSTRY DIRECTORY, *supra* note 13, at 27.

¹⁷ There were 99 million American households in 1995. U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 58 (1996). \$435.7 billion divided by 99 million equals \$4,401.

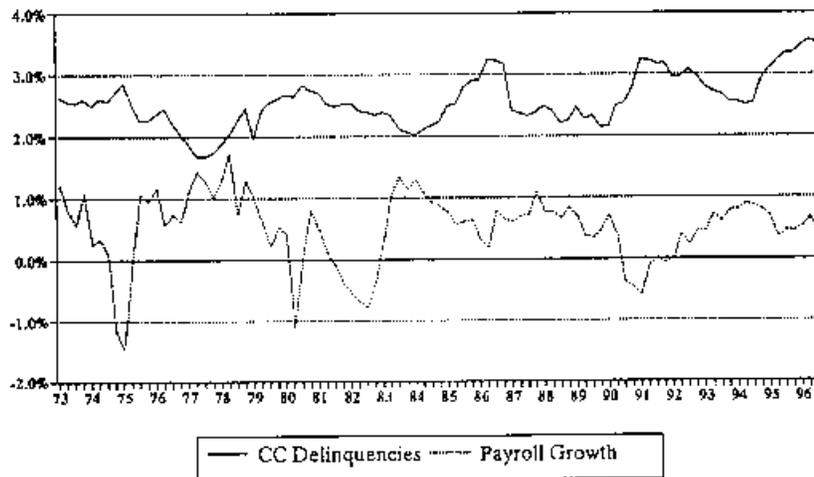
¹⁸ See *generally* 57 Fed. Reserve Bull. (1971) to 82 Fed. Reserve Bull. (1996).

FIGURE 3
Credit Card Chargeoffs and Growth Rate of GDP, 1971–1996



Borrowing from a recent article by Elizabeth S. Laderman of the Federal Reserve Bank of San Francisco,¹⁹ Figure 4 displays the growth rate of nonagricultural payroll in the United States,²⁰ along with the credit card delinquency data series for the years 1973 through 1996 on a quarterly basis.

FIGURE 4
Credit Card Delinquencies and Payroll Growth, 1973–1996



¹⁹Elizabeth S. Laderman, *What's Behind Problem Credit Card Loans?*, Economic Letter (Federal Reserve Bank of San Francisco, San Francisco, Cal.), July 19, 1996, at 96-21.

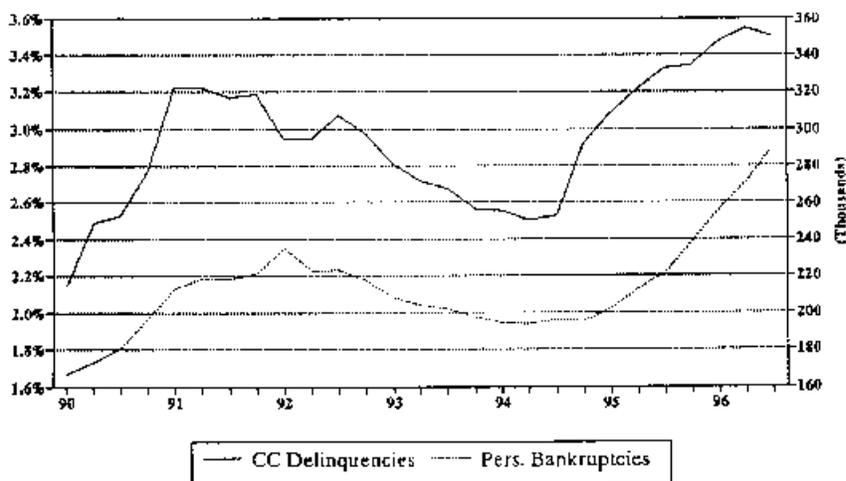
²⁰See generally 59 FED. RESERVE BULL. (1973) to 82 FED. RESERVE BULL. (1996).

In each case, the rate of credit card delinquencies and chargeoffs effectively mirrors the barometer of aggregate economic activity. Upturns in credit card defaults accompany downturns in the United States economy, as well as the reverse. Generally speaking, both changes in the gross domestic product growth rate and changes in payroll employment slightly lead changes in the credit card chargeoffs and delinquencies.

B. RATIO OF DEBT TO DISPOSABLE INCOME

Quite apart from business cycle factors, an increase in the debt burden of households will increase the probability that households cannot meet their debt service requirements. Figure 5, borrowing from recent testimony by Kim J. Kowalewski of the Congressional Budget Office²¹ and a recent article by Donald P. Morgan and Ian Toll of the Federal Reserve Bank of New York,²² displays the ratio of debt to disposable income of American households²³ and the number of personal bankruptcy filings, quarterly for the years 1984 through 1996.²⁴

FIGURE 5
Ratio of Debt to Disposable Income and Personal Bankruptcy Filings, 1984–1996



²¹Hearing on Consumer Debt and Bankruptcy Before the National Bankruptcy Review Commission (Jan. 23, 1997) [hereinafter *Hearing on Consumer Debt and Bankruptcy*] (statement of Kim J. Kowalewski, Chief, Financial and General Macroeconomic Analysis, Congressional Budget Office).

²²Donald Morgan & Ian Toll, *Bad Debt Rising*, CURRENT ISSUES IN ECONOMICS AND FINANCE (Federal Reserve Bank of New York, New York, N.Y.), March 1997, at 1-5.

²³The ratio of debt to disposable income is defined here as the sum of household consumer credit and household home mortgages outstanding divided by disposable personal income. One obtains a qualitatively-similar graph if one instead uses total household debt outstanding divided by disposable personal income. The data is taken from the BD. OF GOVERNORS OF THE FED. RESERVE, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES Z.1 (1996). The revolving credit component of consumer credit is reduced by fifteen percent to reflect the convenience of the use of credit cards. See AUSUBEL, *supra* note 2, at tbl.3.

²⁴See generally AO Report, *supra* note 12.

Since 1984, the bankruptcy rate has generally moved in tandem with the household debt burden. Kowalewski's testimony reports that a fairly close statistical relationship holds for a thirty-five year period,²⁵ while Morgan and Toll's article reports that a somewhat weaker relationship holds between credit card chargeoffs and the household debt burden.²⁶

III. DEFAULTS AND CREDIT CARD PROFITABILITY

Somewhat more subtly, the extent of credit card profitability may broadly influence the level of credit card delinquencies. That is, delinquencies will increase as credit card operations become more profitable. This was a point made in an earlier article by this author published in 1991:

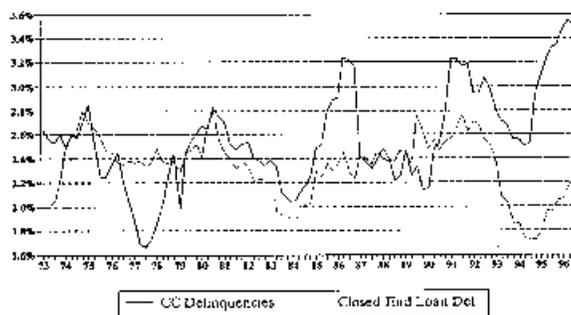
The credit card industry has defended its high interest rates in the mid- to late-1980s, in part, by asserting that the increased spread between the credit card interest rate and the cost of funds had been caused by an increase in the industry's rate of bad loans. The loan-loss data from the author's Bank Credit Card Survey indicate that, in the period 1982 to 1987, the charge-off rate actually did increase roughly coincident with the increase in the interest rate spread However, higher loan losses are an *explanation* for the higher interest rate spreads only if we believe that the latter are solely determined by costs. If credit card interest rates are determined otherwise, then *the causation may run in the reverse direction*: an increased interest rate spread may cause an increase in charge-offs.²⁷

A. DEFAULTS

As shown in Figure 1, credit card delinquencies and chargeoffs have experienced a long-term secular increase from 1971 to 1996. We shall now see that this increase has been largely confined to credit cards and did *not* occur for consumer credit generally.

FIGURE 6

Credit Card Delinquencies and Closed-End Installment Loan Delinquencies, 1973–1996



²⁵See *Hearing on Consumer Debt and Bankruptcy*, *supra* note 21, at fig.2.

²⁶Compare Morgan & Toll, *supra* note 22, at 2 chart 1, with Figure 5 of this Article, *supra*.

²⁷Lawrence M. Ausubel, *The Failure of Competition in the Credit Card Market*, AM. ECON. REV., March 1991, at 50–81, *reprinted in* ADVANCES IN BEHAVIORAL FINANCE, ch. 21 (D. Thaler ed., 1993).

Indeed, Figure 6 demonstrates that the rate of credit card delinquencies has risen over time *relative to* delinquency rates on closed-end installment loans. Figure 6 plots credit card delinquencies as reported by the American Bankers Association's series of percentage of loans past due thirty days or more on a composite of personal, automobile, mobile home, recreational vehicle, marine financing, property improvement, home equity and second mortgage loans.²⁸ The latter delinquencies are substantially countercyclical, with major peaks recorded in 1974, 1980, and 1991. Unlike credit card delinquencies, this data series stably peaks at 2.8 percent and troughs at 1.8 percent, with no discernible time trend. By contrast, peaks and troughs in the credit card delinquency series have trended upward.

B. PROFITABILITY

Not coincidentally, a second important index concerning credit cards increased during the same period, namely, credit card profits. The standard measure used to examine profits in the banking sector is the return on assets. The return on assets for a bank is simply the bank's annualized profits divided by total assets. To the extent that an individual banking activity can be isolated out in a meaningful way, the return on assets for a particular banking activity is, analogously, the annualized profits associated with the activity divided by the assets dedicated to that activity. In the case of credit cards, the return on assets is computed by multiplying the bank's quarterly profits associated with the credit card business by four and dividing the result by the bank's average outstanding credit card balance over the quarter.²⁹ Frequently, one is interested in the combined return on assets for the entire United States banking system or the combined return on assets for the entire United States bank card system; these are computed by simply summing together all the individual institutions' profit and asset figures, respectively, and computing the analogous ratios as before.

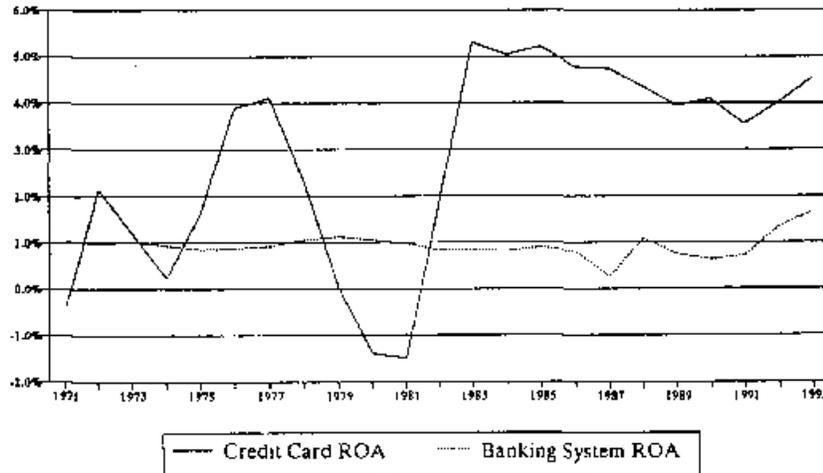
A prior article written by this author in 1995 contrasted the return on assets for the credit card industry with the return on assets for the United States banking system at large during the period 1971–1993.³⁰ The comparison—displayed in Figure 7—is fairly striking.

²⁸See generally 383 CONSUMER CREDIT DELINQUENCY BULL. (American Bankers Association), First Quarter 1973, to 475 CONSUMER CREDIT DELINQUENCY BULL. (American Bankers Association), First Quarter 1996.

²⁹Oftentimes, the average daily outstanding balance over a quarter is unavailable; then the average of the beginning-of-quarter outstanding balance and the end-of-quarter outstanding balance is used or, alternatively, simply the end-of-quarter outstanding balance is used, with little harm.

³⁰See generally AUSUBEL, *supra* note 2.

FIGURE 7
**Profitability of Credit Cards vs.
 Profitability of Overall Banking System**



The profitability of the overall United States banking system was relatively stable over this period: the pre-tax return on assets averaged 0.97 percent over the years 1971–1982 and 0.91 percent over the years 1983–1993. By contrast, the profitability of credit card activity sharply increased around 1982. The pre-tax return on assets equaled an average of 1.19 percent during the years 1971–1982, but jumped to an average of 4.5 percent during the years 1983–1993.

It should be noted that the return on assets implies a return on equity via the banking system’s capital requirement. During much of the time period studied, United States banks were required to maintain a six-percent capital requirement. This meant, for example, that in order for a bank to lend \$100 million in credit card balances, the bank was required to advance \$6 million of its own capital; the remaining \$94 million could be raised by accepting deposits, issuing securities, and the like. Thus, a one percent pre-tax return on assets would have implied a 16.67 percent pre-tax return on equity.³¹ Similarly, a 4.5 percent return on assets would have implied a seventy-five percent return on equity.³² Note, however, that during the 1990s, United States banks have been subject to increased capital requirements. For example, on March 31, 1996, the equity capital of the combined United States banking system stood at \$378 billion and the total assets of the combined United States banking system stood at \$4,565 billion, for an effective capital ratio of 8.3 percent.³³ Thus, during the 1990s, a given return on assets would imply a return on equity approximately one-fourth lower than before.

³¹As 0.010 divided by 0.060 equals 0.1667.

³²As 0.045 divided by 0.060 equals 0.75.

³³CONSOLIDATED REPORTS OF CONDITION AND INCOME (Federal Financial Institutions Examination Council), March 31, 1996.

IV. DEREGULATION AND THE INCREASE IN CREDIT CARD PROFITABILITY

What explains the sharp rise in the rate of credit card profitability? The answer lies in the fact that since approximately 1982 the United States credit card market has been functionally deregulated while the ensuing competitive process has failed to drive down profits to the ordinary rate of return.³⁴

A. DEREGULATION

Before 1982, credit card interest rates were subject to usury ceilings in most states.³⁵ These ceilings on interest rates limited credit card profitability during periods, such as 1974–1975 and 1980–1981, when market interest rates on Treasury bills and corporate bonds spiked upward.³⁶ This led to a sharply-reduced or negative return on assets for credit card activity during such years.³⁷ However, during the 1970s, the banking industry heavily litigated the issue of the “exportation” of interest rates, i.e., the issue of which state’s usury ceiling constrains the interest rate if a bank located in one state issues a credit card to a consumer in a different state.³⁸ In *Marquette National Bank v. First of Omaha Service Corporation*,³⁹ the United States Supreme Court resolved this controversy by ruling that the usury ceiling in the state where the bank is located applies.⁴⁰ This set the stage for state legislatures to repeal their usury ceilings in order to entice banks to move their credit card operations to the state. By 1982, amid *Marquette*-created bank pressure and historically high market interest rates, South Dakota and Delaware established themselves as attractive homes-away-from-home for credit card issuers.⁴¹ By this time also, most leading banking states had relaxed or repealed their interest rate ceilings.⁴²

Throughout the remainder of the 1980s, credit card interest rates displayed a profound unresponsiveness to changes in the cost of funds.⁴³ While the relevant market interest rates varied widely from six percent to fourteen percent,⁴⁴ the annual percentage rate on credit cards remained within a tight band of eighteen or nineteen percent.⁴⁵ Thus, in the face of broad declines in the issuers’ costs of funds and decreases also in their operating expenses,⁴⁶ the return on assets on credit cards equaled roughly four times the return on assets on banking activities generally.⁴⁷

³⁴Ausubel, *supra* note 27, at 53.

³⁵*See, e.g.*, DEL. CODE ANN. tit 6, ' 2301 (1976); IOWA CODE ' 537.1101 (1976); MINN. STAT. ' 48.185 (1976); NEB. REV. STAT. ' 8-815 (1976); S.D. CODIFIED LAWS ' 54-3-7 (1976).

³⁶*See generally* 60 FED. RESERVE BULL. (1974) to 61 FED. RESERVE BULL. (1975); 66 FED. RESERVE BULL. (1980) to 67 FED. RESERVE BULL. (1981).

³⁷*See supra* Figure 7 of this Article.

³⁸*See, e.g.*, *Fisher v. First Nat'l Bank of Omaha*, 548 F.2d 255 (8th Cir. 1977); *Fisher v. First Nat'l Bank of Chicago*, 538 F.2d 1284 (7th Cir. 1976); *Iowa ex rel. Turner v. First of Omaha Serv. Corp.*, 269 N.W.2d 409 (1978).

³⁹439 U.S. 299 (1978).

⁴⁰*Id.* at 310-12.

⁴¹Ausubel, *supra* note 27, at 52.

⁴²Vincent D. Rougeau, *Rediscovering Usury: An Argument for Legal Controls on Credit Card Interest Rates*, 67 U. COLO. L. REV. 1, 10 (1996).

⁴³Ausubel, *supra* note 27, at 50.

⁴⁴*See id.* at fig.1.

⁴⁵*Id.*

⁴⁶*See* AUSUBEL, *supra* note 2, at tbl. 1.

⁴⁷Ausubel, *supra* note 27, at 50; AUSUBEL, *supra* note 2, at 9.

B. UNDERESTIMATION

The economic puzzle surrounding the credit card market of the 1980s was why competition among the more than four thousand card-issuing banks⁴⁸ did not lead credit card interest rates to follow decreases in the cost of funds? As a partial resolution of this conundrum, in my earlier 1991 article I advanced the “underestimation hypothesis”: i.e., the proposition that many consumers systematically underestimate the extent of their current and future credit card borrowing and, using these underestimates, make suboptimal decisions regarding the choice and usage of credit cards.⁴⁹ In particular, consumers underestimate their credit card balances and, thus, underrate the importance of credit card interest rates, which can lead to an “adverse selection” problem associated with rate-cutting:

Since a credit card is really quite an expensive medium on which to borrow, let us posit a class of consumers who do not intend to borrow on their accounts, but find themselves doing so anyway. Consumers in this first class are precisely the best customers from a (rational) bank’s viewpoint: they do borrow at high interest rates, yet they eventually (in most cases) repay their loans. At the same time, these consumers are unlikely to be responsive to any interest rate cut by a bank, as they do not intend to borrow at the outset.

Let us also assume a second class of consumers who fully intend to borrow on their credit card accounts. These are the consumers who are bad credit risks and thus lack less expensive alternatives—bank cards are their best sources of credit. Consumers in the second class are less than ideal from a bank’s perspective: they borrow large sums, but often default. Insidiously, these customers are more likely to comparison shop on interest rates than the better credit risks, as they actually plan to be paying substantial finance charges. (There is also a third class of consumers—the “convenience” users—who we can neglect in this discussion. They never borrow on their credit cards and, thus, [rationally] are completely unresponsive to interest rate differentials).

Given this environment of consumers, banks will be hesitant to compete in the interest rate dimension, as a lower price on credit would disproportionately draw the latter class of consumers who plan to utilize their credit lines.⁵⁰

A recent phenomenon is that, in the 1990s, a subset of credit card interest rates have begun to display clear-cut competitive pressures. It is now commonplace for issuers to offer “teaser” interest rates—as low as 5.9–8.9 percent—for the first six to eighteen months a new cardholder is a customer.⁵¹ Two explanations can be advanced for this new form of pricing. First, consumers may have become more realistic about their current levels of borrowings, but the underestimation hypothesis may still powerfully apply to borrowings beyond the introductory period. The most desirable group of customers would then be strongly attracted by the promise of a low interest rate today, but would underestimate the relevance of the much-higher interest rate some months down the road. Second, economic theory suggests that firms in a market with substantial search/switch costs⁵² will find advantage in utilizing introductory offers

⁴⁸Ausubel, *supra* note 27, at 51.

⁴⁹*See id.* at 70–71. *See also* AUSUBEL, *supra* note 2, at 21.

⁵⁰Ausubel, *supra* note 27, at 70.

⁵¹After the introductory period, interest rates generally revert to a level in the 15–17 percent range.

⁵²For search costs, see Peter A. Diamond, *A Model of Price Adjustment*, 3 J. OF ECON. THEORY 156 (1971). For switch costs, see Joseph Farrell & Carl Shapiro, *Dynamic Competition with Switching Costs*, 19 RAND J. OF ECON. 123 (1988); Paul Klemperer, *Markets with Consumer Switching Costs*, 102 Q. J. OF ECON. 375 (1987).

or sign-up bonuses to lure new customers.⁵³ Apparently, for this reason sign-up bonuses have also become prevalent in today's long-distance telephone market.⁵⁴

Credit card pricing in the 1990s still leaves considerable profits for issuers, however, for three reasons. First, a substantial portion of credit card borrowing still occurs at post-introductory interest rates, and the spread between post-introductory rates and the cost of funds remains substantial.⁵⁵ Thus, finance charges paid to credit card issuers have not dropped as much as the introductory offers might suggest. Second, issuers in the 1990s have dramatically increased "hidden fees" such as late-payment and overlimit fees: revenues from hidden fees are estimated to have risen from \$1.11 billion in 1991 to \$3.1 billion in 1995.⁵⁶ The recent decision of the United States Supreme Court in *Smiley v. Citibank (South Dakota), N.A.*,⁵⁷ which allows exportation of late-payment fees, makes it almost certain that revenues from hidden fees will continue to rise. Third, issuers' operating expenses as a percentage of outstanding balances have continued to decline in the 1990s.⁵⁸

V. THE CONSEQUENT INCREASE IN CREDIT CARD DEFAULTS

Consider any competitive environment in which the profit margin on every good customer a firm can obtain is sufficiently large to yield extranormal profits. In any such situation, the firm will have every incentive to invest extraordinary resources toward obtaining new customers. In the case of the credit card market, there are several dimensions along which an issuer may be willing to invest extra resources, if that will generate additional customers. For example, the issuer can easily justify an increase in its advertising expenditures, an increase in the generosity of its introductory offers, and an increase in the riskiness of its customer base.

Each of these increases in resource expenditure can easily be empirically observed in the United States credit card market today. For example, it has been estimated that, in 1995, credit card issuers mailed out a record 2.7 billion direct-mail solicitations, more than two solicitations per month per American household.⁵⁹ The number of telemarketing solicitations has clearly also exploded.⁶⁰ The low teaser rates of 5.9–8.9 percent for the first six to eighteen months are also consistent with heightened profit margins

⁵³Farrell & Shapiro, *supra* note 52, at 387; Ausubel, *supra* note 27, at 69.

⁵⁴Edmund L. Andrews, *No-Holds-Barred Battle for Long-Distance Calls*, N.Y. TIMES, Jan. 21, 1995, at 1.

⁵⁵In November 1996, for example, the typical credit card interest rate was 15.62 percent and the one-year Treasury bill yield was 5.42 percent. 83 FED. RESERVE BULL., Feb. 1997, at A23 tbl.1.35; 83 FED. RESERVE BULL., Apr. 1997, at A36 tbl.1.55. A good measure of the cost of funds for credit card issuers is the one-year Treasury bill yield plus 0.75 percent. Ausubel, *supra* note 27, at 53.

⁵⁶CARD INDUSTRY DIRECTORY, *supra* note 13, at 18.

⁵⁷116 S. Ct. 1730 (1996).

⁵⁸See AUSUBEL, *supra* note 2, at tbl. 1.

⁵⁹Saul Hansell, *A Shaky House of Plastic with No Quick Fix in Sight*, N.Y. TIMES, Dec. 28, 1995, at D1. There were 99 million American households in 1995. STATISTICAL ABSTRACT OF THE UNITED STATES, *supra* note 17, at 58. 2.7 billion divided by 99 million divided by 12 equals 2.27.

⁶⁰In 1993, eighty-three percent of the largest banks used telemarketing in the solicitation of credit card accounts, as compared to seventy-nine percent in 1992 and only fifty-six percent in 1991. Compare AM. BANKERS ASS'N, 1994 BANK CARD INDUSTRY REPORT 78 (1994), with AM. BANKERS ASS'N, 1993 BANK CARD INDUSTRY REPORT 29, 60 (1993).

in the post-introductory period.⁶¹ And, the long-term increase in the rate of defaults is clearly consistent with enhanced profitability from the average nondefaulting customer.

To a first approximation, the credit card issuer can look to the return on assets, *gross* of credit card defaults. Any time the annual return on assets increases by one percent, the profit-maximizing issuer should be willing to tolerate a one percent increase in the annual probability that its marginal customer will default. Thus, an increase in the profitability of issuing credit cards should be expected to lead to an *increase* in actual defaults and actual bankruptcies.

Moreover, to the extent that alternative devices for attracting new customers become less effective, credit card issuers may be increasingly drawn to reducing their standards of creditworthiness. For example, the observer may speculate that consumers' mailboxes and telephones have become completely saturated by credit card solicitations; indeed, industry reports indicate that response rates to solicitations have been dropping in recent years.⁶² If alternative methods of obtaining new customers become ineffective, issuers may find no substitute for the relaxation of credit standards. It would not be completely surprising if the rate of credit card defaults continues to trend further upward in the future.

VI. IMPLICATIONS FOR BANKRUPTCY LAW

A. INDUSTRY'S PROPOSALS FOR CHANGE

In the face of the current record levels of credit card default and bankruptcy, representatives of the credit card industry have called for changes in the law which would limit the dischargeability of credit card debt in bankruptcy. The foregoing data and analysis would suggest that such proposals are substantially misdirected. If adopted, they would most likely lead to an *increase* in the level of credit card debt among persons least able to afford it and would possibly result in a generally worsened social outcome.

For example, the credit card industry recently proposed to the National Bankruptcy Review Commission that the Bankruptcy Code be amended to "provide that debts incurred without a reasonable expectation
⁶³ This proposal is intended to preclude "discharge for a debt incurred at a time when the consumer had no income and therefore had no reasonable expectation or ability to repay the debt."⁶⁴ By way of contrast, courts today appear to generally apply a standard that debt will be considered nondischargeable if it is incurred with no *intention* to repay.⁶⁵ While the card industry

⁶¹AUSUBEL, *supra* note 2, at 30.

⁶²Hansell, *supra* note 59, at 1.

⁶³*Written Statement of Kenneth R. Crone Before the National Bankruptcy Review Commission 2-3* (Dec. 17, 1996) (statement of Kenneth R. Crone, Senior Vice President, Visa U.S.A., Inc.). The statement indicates that it was submitted on behalf of the following organizations: the American Bankers Association, America's Community Bankers, the American Financial Services Association, the Consumer Bankers Association, the Credit Union National Association, the Independent Bankers Association of America, MasterCard International, Inc., the National Retail Federation, and Visa U.S.A., Inc.

⁶⁴*Id.*

⁶⁵In attempting to have their debts excepted from a debtor's discharge, credit card issuers have generally argued that credit card debts should be nondischargeable under §523(a)(2)(A) of the Bankruptcy Code as debts for money, property or services obtained by "false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition." To prevail under §523(a)(2)(A), a creditor must prove that:

- (1) the debtor made a representation;
- (2) the debtor knew the representation to be false when made;
- (3) the debtor made the false representation with the purpose and intention of deceiving the creditor;

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- (4) the creditor actually and justifiably relied on the debtor's representations; and
 - (5) the creditor sustained the alleged loss and damage as the proximate result of the misrepresentations having been made.

See, e.g., Am. Express Travel Related Servs. v. Hashemi (*In re Hashemi*), 104 F.3d 1122, 1125 (9th Cir. 1996). *See also* Field v. Mans, 116 S. Ct. 437, 445-46 (1995) (holding that §523(a)(2)(A) requires justifiable, but not reasonable, reliance). Because direct communication between the debtor and the credit card issuer is quite rare in most credit card transactions, the elements of §523(a)(2)(A) are rather awkwardly applied to credit card nondischargeability cases. As a result, there is a confusing and sometimes overlapping split of authority as to how §523(a)(2)(A) should be applied to cases where credit card issuers seek to except their debts from discharge.

The majority approach, "the implied representation" theory, states that each time a debtor uses a credit card the debtor makes an implied representation that the debtor has the ability and the intention to pay for the goods or services charged. *See, e.g.*, Am. Express Travel Related Servs. Co., Inc. v. Nahas (*In re Nahas*), 181 B.R. 930 (Bankr. S.D. Ind. 1994); FCC Nat'l Bank v. Branch (*In re Branch*), 158 B.R. 475 (Bankr. W.D. Mo. 1993); Citicorp Credit Servs. v. Hinman (*In re Hinman*), 120 B.R. 1018 (Bankr. D.N.D. 1990). Under this theory, the purchase of goods with credit cards by a debtor who has no reasonable expectation of paying for them constitutes false pretenses or fraud, and the debt is nondischargeable under §523(a)(2)(A). Some courts have modified this theory to provide that each time a debtor uses a credit card the debtor makes an implied representation that the debtor has the intention to repay the debt, but not that the debtor has the ability to repay the debt. *See, e.g.*, Hashemi, 104 F.3d 1122; Anastas v. Am. Sav. Bank (*In re Anastas*), 94 F.3d 1280 (9th Cir. 1996). These cases generally hold that a debtor's implied representation that he has the ability to repay would be a representation of the debtor's "financial condition," which is beyond the scope of

Id. These cases also state that the focus should not be on whether the debtor was hopelessly insolvent at the time the debtor made the credit card charges, as this would too often lead to conclusions of bad faith in cases of honest but unfortunate debtors. Instead, the inquiry should be on whether the debtor maliciously and in bad faith incurred the credit card debt with the intention of petitioning for bankruptcy and avoiding the debt. *Id.*

Several courts, expressing dissatisfaction with the "implied representation" theory, have utilized a "totality of the circumstances" approach to determine whether a debtor intends to deceive credit card issuers. These courts determine a debtor's intent by considering the following list of 12 objective factors:

- (1) The length of time between the charges made and the filing of bankruptcy;
- (2) Whether or not an attorney has been consulted concerning the filing of bankruptcy before the charges were made;
- (3) The number of charges made;
- (4) The amount of the charges;
- (5) The financial condition of the debtor at the time the charges were made;
- (6) Whether the charges were above the credit limit of the account;
- (7) Whether the debtor made multiple charges on the same day;
- (8) Whether or not the debtor was employed;
- (9) The debtor's prospects for employment;
- (10) The debtor's financial sophistication;
- (11) Whether there was a sudden change in the debtor's buying habits; and
- (12) Whether the purchases were made for luxuries or necessities.

See Hashemi, 104 F.3d at 1125 n.2; *Anastas*, 94 F.3d at 1284 n.1; Citibank, S.D., N.A. v. Eashai (*In re Eashai*), 87 F.3d 1082 (9th Cir. 1996); Citibank, S.D., N.A. v. Dougherty (*In re Dougherty*), 84 B.R. 653 (B.A.P. 9th Cir. 1996); AT&T Universal Card Servs. Corp. v. Chinchilla (*In re Chinchilla*), 202 B.R. 1010 (Bankr. S.D. Fla. 1996).

Another group of cases adopts the "assumption of risk" approach, which states that a cardholder makes a false representation to the issuer only when the issuer's revocation of the card is communicated to the cardholder and the cardholder continues to use the card. Thus, under this theory, the credit card issuer assumes the risk that an insolvent debtor will use the card unless and until the credit card company unequivocally and unconditionally revokes the debtor's right to use the credit card. *See, e.g.*, Manufacturer's Hanover Trust Co. v. Ward (*In re Ward*), 857 F.2d 1082 (6th Cir. 1988); Chase Manhattan Bank v. Carpenter (*In re Carpenter*). *See also* First Nat'l Bank v. Roddenberry (*In re Roddenberry*), 701 F.2d 927 (11th Cir. 1983) (applying the "assumption of risk" theory under the Bankruptcy Act of 1898).

proposal uses language which is quite appealing on the surface, the reader should observe that, under current industry practice, new preapproved credit cards are being offered to consumers whose financial condition has already so sufficiently deteriorated that the proposed rule would make bankruptcy protection from further debts inaccessible.

Similar to the card industry proposal, one commentator recently proposed in the pages of *The Wall Street Journal*: “Certain types of credit card charges should not be dischargeable Credit card debt run up to cover gambling debts should not be dischargeable.”⁶⁶ Again, the proposal uses subdued language which seems reasonable on its face, but conveniently ignores the fact that card issuers today are willingly lending to consumers with knowledge that cash advances are going for nondischargeable purposes. For example, credit card issuers today typically permit their customers to take cash advances on their accounts from automatic teller machines located *inside* gambling casinos.⁶⁷ If card organizations were truly troubled by the use of credit cards for gambling purposes, they could curtail the practice immediately by forbidding their member banks to give cash advances in or near casinos—without awaiting changes in United States bankruptcy law.

B. “INSTITUTIONAL HYPOCRISY”

Indeed, a recent opinion, *AT&T Universal Card Services v. Chinchilla (In re Chinchilla)*,⁶⁸ has criticized one card issuer for “institutional hypocrisy” in its attempts to limit dischargeability. In *Chinchilla*, AT&T Universal Card Services had sought to except \$7,200 in credit card debt from discharge. The court questioned how AT&T could point to the debtor exceeding his \$6,500 credit limit by \$100 as an “indicia

Yet another group of courts has adopted a fourth approach to credit card dischargeability cases that allows credit card debts to be excepted from discharge only where a debtor’s *subjective intent* to deceive the credit card issuer can be determined by examining all the facts on a case by case basis. See, e.g., *AT&T Universal Card Servs. v. Feld (In re Feld)*, 203 B.R. 360 (Bankr. E.D. Pa. 1996); *Chevy Chase Bank, FSB v. Briese (In re Briese)*, 196 B.R. 440 (Bankr. W.D. Wis. 1996); *Household Credit Servs., Inc. v. Jacobs (In re Jacobs)*, 196 B.R. 429 (Bankr. N.D. Ind. 1996); *Chase Manhattan Bank v. Murphy (In re Murphy)*, 190 B.R. 327 (Bankr. N.D. Ill. 1995).

Finally, a few recent cases have held that a debtor’s use of a credit card involves no form of representation at all, express or implied. By so holding, these cases suggest that §523(a)(2)(A) has no application to credit card transactions at all. See *AT&T Universal Card Servs. v. Alvi (In re Alvi)*, 191 B.R. 724 (Bankr. N.D. Ill. 1996); *G.M. Card v. Cox (In re Cox)*, 182 B.R. 626 (Bankr. D. Mass. 1995).

⁶⁶Diana Culp Bork, *Why Personal Bankruptcies are Surging*, WALL ST. J., Jan. 29, 1997, at A11. In one of the most prominent credit card gambling debt cases, *Anastas v. American Savings Bank (In re Anastas)*, 94 F.3d 1280 (9th Cir. 1996), the debtor held a Visa card from American Savings Bank which he extended beyond its limit to take cash advances for gambling at Lake Tahoe casinos. At the time the debtor filed for Chapter 7 protection, the debtor’s accumulated credit card debt totaled approximately \$40,000, with a monthly take-home income of \$3,465 and estimated monthly expenditures of \$3,535. The United States Bankruptcy Court for the Eastern District of California ruled that the debt was nondischargeable, and the debtor appealed. The United States Bankruptcy Appellate Panel for the Ninth Circuit affirmed, and the debtor appealed to the United States Court of Appeals for the Ninth Circuit.

The Ninth Circuit reversed, stating that the relevant inquiry for §523(a)(2)(A) purposes is whether, when making each individual charge, the debtor lacked the intent to repay because he planned to shortly discharge them in bankruptcy. The *Anastas* court concluded that the credit card debts were dischargeable, stating that although it may have been unlikely that the debtor would win enough money to pay back the credit card debt, there was no evidence in the record that the debtor lacked the good faith intention to do so. See also *AT&T Universal Card Servs. v. Totina (In re Totina)*, 198 B.R. 673 (Bankr. E.D. La. 1996); *Briese*, 196 B.R. 440; *Alvi*, 191 B.R. 724; *Murphy*, 190 B.R. 327 (holding gambling credit card debts to be dischargeable). But see *Eashai*, 87 F.3d 1082; *Nahas*, 181 B.R. 930; *Chemical Bank v. Clagg (In re Clagg)*, 150 B.R. 697 (Bankr. C.D. Ill. 1993 (holding gambling credit card debts to be nondischargeable).

⁶⁷Chris Ison, *Dead Broke*, MINNEAPOLIS STAR TRIB., Dec. 5, 1995, at A1.

⁶⁸202 B.R. 1010 (Bankr. S.D. Fla. 1996).

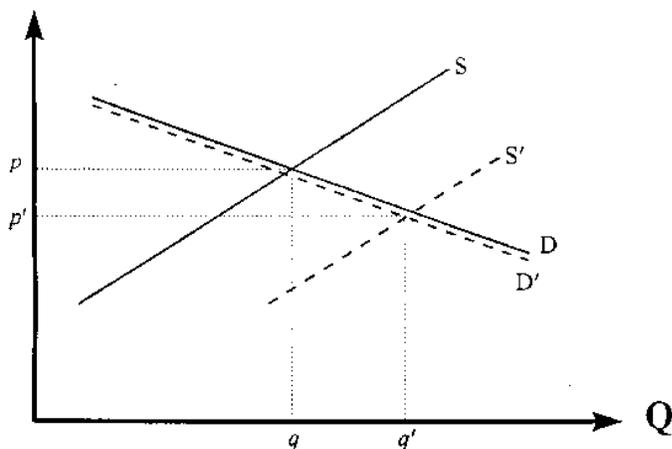
of fraud,” when AT&T’s response at the time was to immediately grant the debtor an unsolicited \$2,000 increase in his credit limit. The credit increase may have also made the court skeptical regarding AT&T’s claim that the debtor’s financial condition when he incurred the charges rendered him incapable of repaying the charges. In awarding the debtor the attorney’s fees and costs incurred in defending the unjustified complaint, Bankruptcy Judge Robert A. Mark wrote:

AT&T’s emphasis on its cardholders’ financial condition is not only legally insufficient, it is another disturbing display of institutional hypocrisy. At the marketing stage, credit sellers like AT&T actively solicit new business with limited knowledge of the financial condition of their targeted customers. Mr. Chinchilla’s AT&T card was pre-approved and sent to him unsolicited. The targets of these solicitations undoubtedly include already overextended consumers who are still able to make the advertised low minimum payments. Once a card is issued, many of these new customers pay only the minimum monthly payments and the card companies eagerly apply high interest rates to the unpaid balance generating substantial profits.⁶⁹

C. ECONOMIC ANALYSIS

Let us now consider a very simple microeconomic analysis of a restriction on bankruptcy protection for credit card debt.

FIGURE 8



In Figure 8, we begin with a supply curve (denoted S) and a demand curve (denoted D) for balances on credit cards. What is the likely effect of the proposed limitations on dischargeability on the supply curve? Credit card issuers should be expected to rationally recognize that the probability of credit card default has been reduced by the change in law and, thus, they should be willing to lend increased quantities of debt at any given price (e.g., interest rate). Thus, we should anticipate an outward shift in the supply curve, from S to S', in Figure 8.

⁶⁹*Id.* at 1015-16 (footnotes omitted).

What is the likely effect of the proposed limitations on dischargeability on the demand curve? Credit card customers should be expected to exhibit very little change in their borrowing behavior, for at least two reasons. First, unlike issuers, many credit card customers will fail to learn (at the time they are borrowing) about fairly technical changes in bankruptcy law. Second, even to the extent that consumers do learn of the change in the law, the underestimation hypothesis strongly suggests that consumers will fail to act on the information. Just as many consumers may systematically underestimate the extent of their current and future credit card borrowing, it should be expected that many consumers may systematically underestimate (at the time they borrow) the probability with which they will eventually fall into bankruptcy. Many or most consumers will underestimate the likelihood that the technical rules of bankruptcy will apply to them, and hence they will underreact to changes in the bankruptcy law. Thus, we should anticipate only a minimal shift in the demand curve, from D to D' , in Figure 8.

Let us now see the likely effects of the proposed limitations on dischargeability in the market for credit card lending to marginal customers. The original equilibrium (i.e., the intersection point of S and D) corresponds to a price of p and a quantity of q in Figure 8. As we have seen above, the supply shift (i.e., the increase in the willingness of credit card issuers to lend to marginal customers at a given price) may be substantial. The corresponding demand shift (i.e., the corresponding decrease in the willingness of marginal customers to accept credit at a given price) is fairly negligible and fails to offset the supply shift. Thus, the new equilibrium (i.e., the intersection of S' and D') is associated with a somewhat lower price, p' , than the original equilibrium. However, due to the greater magnitude of the supply shift than the demand shift, the new equilibrium is also associated with a higher quantity, q' , of credit card debt than the original equilibrium.

As depicted in Figure 8, it should be anticipated that the quantity effect will be more substantial than the price effect. The intuition for this prediction is that issuers will act on the change in bankruptcy law, whereas consumers will substantially fail to act. As a result, issuers will increase the pace of credit card solicitations and credit line expansions, while marginal consumers should not be expected to neutralize this effect by declining the issuers' offers.

Paradoxically, we conclude that the likely effect of further limiting the dischargeability of credit card debt in bankruptcy is an *increase* in the outstanding balances of marginal consumers. In our efforts to curtail the incidence of credit card delinquency, we only *increase* the frequency with which consumers are buried under mountains of credit card debt.

CONCLUSION

Credit card delinquencies and personal bankruptcies moved in tandem in the 1990s and both attained record levels in 1996. Their movement together has led some to attribute the increases in credit card defaults to a perceived leniency in the current bankruptcy law and to advocate modifications to bankruptcy law which would restrict the ability of debtors to discharge debts incurred through the use of credit cards. However, this view appears to confuse the direction of causation and more importantly to misperceive the social problem at hand.

The social problem is not so much the rise in personal bankruptcies as the rise in overextended consumers. Many recent proposals to restrict bankruptcy protection overlook this simple fact and naively equate restrictions on the dischargeability in bankruptcy with social improvement. In particular, new

limitations on the dischargeability of credit card debt are likely to have unintended consequences and will probably only worsen the problem of consumer overextension. If changes in the law would be beneficial at all, we need changes directed toward discouraging overextension from occurring in the first place, while preserving the availability of bankruptcy protection and a fresh start in the event that such overextension occurs and becomes overwhelming.
