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PERSONAL BANKRUPTCY IN THE 21ST CENTURY: EMERGING  
TRENDS AND NEW CHALLENGES

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## Optimizing Consumer Credit Markets and Bankruptcy Policy

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# Optimizing Consumer Credit Markets and Bankruptcy Policy

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*This Article explores the relationship between consumer credit markets and bankruptcy policy. In general, I argue that the causative relationships running between borrowing and bankruptcy compel a new strategy for policing the conduct of lenders and borrowers in modern consumer credit markets. The strategy must be sensitive to the role of the credit card in lending markets and must recognize that both issuers and cardholders are well placed to respond to the increased levels of spending and indebtedness. In the latter parts of the Article, I recommend mandatory minimum payment requirements, a tax on distressed credit card debt, and the subordination of payments to credit card lenders in bankruptcy. I also argue that many aspects of the American bankruptcy system, as recently reformed, are overly protective of credit card issuers.*

## INTRODUCTION

Sir Walter Scott was a dominant literary figure at the dawn of the 19th Century. From poems like *The Lay of the Last Minstrel* and *The Lady of the Lake* to novels like *Old Mortality*, *The Heart of Midlothian*, and *The Bride of Lammermoor*, his works display not only an endearing and perceptive infatuation with the troubled history of his Scottish homeland, but a genius of "extraordinary range" and "the greatest diversity of realistic

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human characters outside Shakespeare."<sup>1</sup> To be sure, though there can be no doubt that his work has provided an addictive fascination to generations of readers and served as a fount of inspiration to later writers and composers, critical opinions of his work vary widely. It is fair to say, however, that the conventional wisdom is that his early brilliance was compromised by the much less imaginative work that occupied the last years of his life.

For present purposes, however, Scott is more useful as an example of financial distress. The story is well known. After a dispute with the publisher of his early (and financially successful) poems, Scott founded a new publishing house in 1809 with the Ballantyne Brothers, which quickly became seriously indebted to one Archibald Constable. Over the next few years, Scott's various activities, many of them backed or financed by Ballantyne and Constable, left Scott with debts of about £120,000, quite a large sum, even for the most successful writer of his age. Like many modern individuals, Scott's debts were a tangled mixture of consumer spending (mostly to improve his estate at Abbotsford) and entrepreneurial activity (mostly risk-taking, either borrowing money on the strength of works he had not yet written, or expending money to publish the works of lesser-known favorites of his).

In the end, Constable became insolvent because of speculative investments that failed in connection with an 1825 panic in London. Because Scott's borrowings had left him with secondary liability on many of Constable's obligations, Scott was unable to respond to his own obligations. One option available to Scott was to file bankruptcy, which would have provided considerable relief, though he would have lost his estate at Abbotsford and several public offices that he held dear. Instead, Scott chose to enter into a voluntary arrangement with his creditors, under which they would receive all revenues from subsequent literary works until Scott's debts were repaid. The remaining six years of Scott's life were consumed by a grinding productivity that produced a torrent of novels and other works. The earnings from Scott's works ultimately did pay off his debts, but not until fifteen years after his death, which surely was hastened by the pace of work and emotional strain of his last years.

Some regard Scott as an example of the good old days, when a combination of stigma, shame, and the rigors of bankruptcy prevented an easy flight from obligation. So, for example, Judge Edith Jones and Todd Zywicki describe this and the story of Mark Twain as "the tales of honest and noble individuals

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1 A.N. Wilson, *The Laird of Abbotsford* 4, 185 (1980).

. . . who worked for years to repay their debts . . . ."<sup>2</sup> More generally, the choice to avoid bankruptcy is valorized:

Bankruptcy represents a repudiation of one's promises, a decision not to bestow a reciprocal benefit on someone who has given you something of value. As a result, filing bankruptcy traditionally has been treated as a socially shameful act. Promise-keeping and an instinct for fairness and reciprocity are deeply embedded in our natures and underlie our social structure. It is not surprising that most people feel great personal shame from a failure to keep their promises. It is also not surprising that society punishes and stigmatizes an individual's failure to keep his promises. Personal shame and social stigma go hand-in-hand. Shame is the internal, psychological compass that forces one to keep his word; stigma is the external, social constraint that reinforces this.<sup>3</sup>

There is of course some truth in that perspective, however much it brings to mind the style of Gradgrind in *Hard Times*. Still, it is not unreasonable to look with disappointment on the poor work — "trashy" in Scott's own words<sup>4</sup> — that occupied the last years of his life. Would society as a whole have been better off if Scott's entrepreneurial debts had been wiped away and he had written three great literary works during those last six years? What if he had not literally worked himself to death, and instead had an additional five years within which to produce a masterpiece to crown his oeuvre? Would it matter if spillovers from those works had led to important follow-on creations — perhaps another series of major operas like those founded on earlier novels? More prosaically, is society better off if the perils of entrepreneurial failure deter people like Scott from taking the risks involved in starting the business ventures that were largely responsible for Scott's insolvency?

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In modern economies, credit cards are the instrument for discretionary and entrepreneurial spending; indeed, credit cards now have a pervasive influence over most consumer lending and payment transactions. They introduce substantial cost savings by shifting consumers from paper-based payments

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2 Edith H. Jones & Todd J. Zywicki, *It's Time for Means-Testing*, 1999 BYU L. Rev. 177, 221.

3 *Id.* at 216.

4 Wilson, *supra* note 1, at 158 (quoting Scott's comments that *Anne of Geierstein* had turned out "more trashy than I expected" and that he "hate[d] Anne").

and closed-end bank loans to card-based (and mostly electronic) payment and borrowing transactions. In addition, they are available to entrepreneurs even when conventional bank lending is not. Yet credit cards do not just speed up checkout lines and reduce the waiting times in bank lobbies. They blur the lines between conventional payment and borrowing decisions, and, in doing so, they are associated with substantial increases in consumer spending and borrowing levels. Moreover, these trends are occurring against a backdrop of increased demand on social welfare programs and rising bankruptcy rates.

Industry advocates do not fault the credit card product, but rather attribute the greater levels of financial distress to the profligacy of consumers. Indeed, as discussed below, the legislative desire to protect the credit card's place in the American economy was one of the most important motivations for the recently adopted Bankruptcy Abuse and Consumer Protection Act of 2005.<sup>5</sup> Others place much more of the blame on the product, claiming that card issuers exploit cognitive defects of consumers that lead them to incorrectly assess the risks of lending transactions. Advocates of that approach naturally prefer lenient bankruptcy systems and strict controls on lending practices of credit card issuers (typically in the form of usury restrictions). Assuming that the causation question is more complicated than either approach admits, this Article looks closely at bankruptcy policy and credit market regulation in the modern age of the credit card.

In Part I, I begin by sorting out some of the realities of consumer lending markets, focusing on the ways that the leniency of the bankruptcy system might affect the size of those markets and the ways in which the openness of the credit markets might drive the need for a lenient bankruptcy system. In Part II, I turn to consumer credit regulation. Generally, I argue that usury reforms have only a limited prospect for success, largely because of their inability to distinguish between value-increasing and value-decreasing transactions. Thus, I propose two alternate approaches. The first would be to impose mandatory minimum payments on credit card contracts. Although that might be useful, a better approach, I argue, would be a tax on distressed debt, particularly defaulted credit card debt. Finally, in Part III, I return to bankruptcy policy, challenging the assumption of existing work that the purpose of bankruptcy policy should be to alter the incentives of borrowers to avoid financial distress and bankruptcy. Rather, I contend, the task is to allocate the losses between borrowers and lenders in a way that minimizes

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<sup>5</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

the net costs of financial distress. Generally, I argue that this calls for rules placing more risks on lenders, so that they will have an incentive to use information technology to limit the costs of distress.

### I. CAUSATION, CONSUMER CREDIT, AND BANKRUPTCY

It is not novel to claim an inextricable link between consumer credit markets and bankruptcy. It is, still, a challenge to understand the nature of the link and the implications it holds for policymakers. For example, prominent economic analysts have explored the likelihood that expansion of the bankruptcy discharge can both increase the demand for credit and decrease the supply.<sup>6</sup> Parallel work has considered the effect of bankruptcy exemptions on the supply and demand for credit.<sup>7</sup> An important problem for either analysis, underscored by Tom Jackson, has been the likelihood that quasi-rational behavioral biases of consumers undermine the policy prescriptions one might draw from models focused on fully rational actors.<sup>8</sup>

Historical and political economy perspectives, in contrast, focus on the possibility that the expansion of the supply of credit necessitates a broader discharge. Several writers, for example, have pointed out the progression from relaxation of consumer credit regulations in much of western Europe in the 1980s, to increased financial distress by consumers, and finally to the adoption of bankruptcy systems that offer an increasingly more accessible discharge.<sup>9</sup> Writers in the political economy vein consistently have argued that globalizing economies must provide some form of relief (here,

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6 Barry Adler et al., *Regulating Consumer Bankruptcy: A Theoretical Inquiry*, 29 J. Legal Stud. 585 (2000).

7 Michelle J. White, *Personal Bankruptcy: Insurance, Work Effort, Opportunism and the Efficiency of the "Fresh Start"* (2005) (unpublished manuscript), available at <http://www.econ.ucsd.edu/~7Emiwhite/bankruptcy-theory-white.pdf>.

8 Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 Harv. L. Rev. 1393 (1985).

9 Jason Kilborn, *The Innovative German Approach to Consumer Debt Relief: Revolutionary Changes in German Law, and Surprising Lessons for the United States*, 24 Nw. J. Int'l L. & Bus. 257 (2004); Jason Kilborn, *Continuity, Change, and Innovation in Emerging Consumer Bankruptcy Systems: Belgium and Luxembourg*, 14 Am. Bankr. Inst. L. Rev. (forthcoming 2006) [hereinafter Kilborn, *Belgium and Luxembourg*]; Jason Kilborn, *La Responsabilisation de l'Economie: What the US Can Learn from the New French Law on Consumer Overindebtedness*, 26 Mich. J. Int'l L. 619 (2005); Johanna Niemi-Kiesiläinen, *Changing Directions in Consumer Bankruptcy Law and Practice in Europe and USA*, 20 J. Consumer Pol'y 133 (1997); Jay Westbrook, *Local Legal Culture and the Fear of Abuse*, 6 Am. Bankr. Inst. L. Rev. 25 (1998); Teresa Sullivan et al., *The Fragile Middle Class* (2000).

the bankruptcy discharge) for consumers that bear the adverse effects of the unforgiving competitive markets that globalization induces (here, those who borrow to the point of financial distress).<sup>10</sup> Indeed, the United States appears to be unique in responding to rising levels of credit-induced financial distress by making the bankruptcy process less friendly to debtors. I should not make too much of this point, because in many respects the American system still could be viewed as one of the most, if not *the* most, lenient. From that perspective, some (though certainly not I) might argue that the comparative trends reflect convergence on an ideal system.<sup>11</sup>

In truth, however, the link is considerably more complex than those perspectives suggest. For example, data and policy about consumer credit blend two markets with distinct macroeconomic implications and justifications. Thus, a dominating motivation for opening consumer credit markets is the hope that an increase in consumer credit will jump-start consumer spending and thus lead to overall growth of the economy. The most noted example is South Korea. However, the policy intuition is widely followed in the United States and elsewhere.<sup>12</sup> Although the academic literature strongly supports the idea that loosening credit constraints can increase personal consumption, it is much more ambiguous on the relation between personal consumption and real economic growth.<sup>13</sup>

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10 See Raghuram G. Rajan & Luigi Zingales, *Saving Capitalism from the Capitalists* (2003) (asserting that thesis). Mark Roe has made the most detailed explication of this point in the legal context. Mark J. Roe, *Backlash*, 98 Colum. L. Rev. 217 (1998); Mark J. Roe, *Political Determinants of Corporate Governance: Political Context, Corporate Impact* (2003).

11 See Charles Jordan Tabb, *Lessons from the Globalization of Consumer Bankruptcy*, 31 Law & Soc. Inquiry 763 (2005).

12 For example, in the United States, consumer spending represents about 70% of the GDP. US Department of Commerce, Bureau of Economic Analysis, *Gross Domestic Product First Quarter 2005*, available at <http://www.bea.doc.gov/bea/newsrelarchive/2005/gdp105a.pdf> (last visited Mar. 1, 2006). Thus, substantial increases in consumer spending should directly cause an increase in GDP. The basic premise of current Federal Reserve policymaking is that reductions of interest rates will lead directly to increased consumer spending, and thus in turn to an increase in GDP.

13 For some representative citations, compare the more optimistic views in Dean M. Maki, *The Growth of Consumer Credit and the Household Debt Service Burden, in The Impact of Public Policy on Consumer Credit* 43 (Thomas A. Durkin & Michael E. Staten eds., 2002), with the more pessimistic findings in Philippe Bacchette & Stefan Gerlach, *Consumption and Credit Constraints: International Evidence*, 40 J. Monetary Econ. 207 (1997); Sydney Ludvigson, *Consumption and Credit: A Model of Time-Varying Liquidity Constraints*, 81 Rev. Econ. Stat. 434 (1999).

At the same time, there does seem to be a link between entrepreneurship and economic growth. Because entrepreneurs often use personal loans to fund their businesses,<sup>14</sup> the robustness of the bankruptcy system is thought to be an incentive to entrepreneurialism.<sup>15</sup> A telling example is the recent Enterprise Act of 2002, which lowered the discharge period in the UK from three years to one year.<sup>16</sup> Part of the justification was the empirical intuition that a broader discharge would encourage entrepreneurial risk-taking. Academics have tried to test that intuition quantitatively. John Armour, for example, has produced empirical studies suggesting that the leniency of the bankruptcy discharge is associated with measures of the level of entrepreneurial risk-taking — venture-capital investment activity and self-employment, in particular.<sup>17</sup> Michelle White has presented data suggesting that increases in property exemption levels help to foster small-business formation by providing a form of implicit wealth insurance.<sup>18</sup> In a related paper, using plausible values for the level of opportunistic activity in existing debt markets, her models indicate that the optimal bankruptcy system would have a substantial and non-waivable postbankruptcy income exemption — something much like Chapter 7 of the existing Bankruptcy Code.<sup>19</sup> More recently, a study by Robert Lawless and

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- 14 Finance for Small and Medium-Sized Enterprises: A Report on the 2004 UK Survey of SME Finances, *available at* <http://www.wbs.ac.uk/downloads/research/sme-report-may-2005.cfm> (2006) (showing substantial small business use of personal credit cards, particularly by start-ups); Bd. of Governors of the Fed. Reserve, Report to Congress on the Availability of Credit to Small Businesses, *available at* <http://www.federalreserve.gov/boarddocs/RptCongress/sbfreport2002.pdf> (Sept. 2002) (showing the same).
- 15 Bruce Mann's historical work shows that this impulse has a lengthy pedigree in this country. Bruce H. Mann, *Republic of Debtors: Bankruptcy in the Age of American Independence* (2002). For more general discussions of the relationship between bankruptcy policy and productivity, see Rafael Efrat, *Global Trends in Personal Bankruptcy*, 76 *Am. Bankr. L.J.* 81 (2002); Nicholas L. Georgakopoulos, *Bankruptcy Law for Productivity*, 37 *Wake Forest L. Rev.* 51 (2002); Richard Hynes, *Overoptimism and Overborrowing*, 2004 *BYU L. Rev.* 127; Richard Hynes, *Non-Procrustean Bankruptcy*, 2004 *U. Ill. L. Rev.* 301, 340-43.
- 16 Insolvency Act, 1986, c. 45, § 279 (Eng.) (as amended by Enterprise Act, 2002, c. 40, § 256 (Eng.)).
- 17 John Armour, *Personal Insolvency Law and the Demand for Venture Capital*, 5 *Eur. Bus. Org. L. Rev.* 87 (2004); John Armour & Douglas J. Cumming, *Bankruptcy Law and Entrepreneurship* (2005) (unpublished manuscript), *available at* <http://law.bepress.com/cgi/viewcontent.cgi?article=1210&context=alea>.
- 18 See Wei Fan & Michelle J. White, *Personal Bankruptcy and the Level of Entrepreneurial Activity*, 46 *J.L. & Econ.* 543 (2003).
- 19 See White, *supra* note 7.



Elizabeth Warren shows that many personal bankruptcy filings are due to small business failures,<sup>20</sup> suggesting that entrepreneurs commonly use the bankruptcy system as a safety net.

Previous academic analyses of credit policy have not focused on the difficulties of untangling the separate effects that entrepreneurial and consumer lending have on credit and bankruptcy policy. It therefore would be a mistake to assume that bankruptcy policy should be structured solely to maximize the efficiency of credit markets. It must account for the separate effects of entrepreneurial and spending activity as well.

### A. Understanding the Link

It is easier to recognize that there is a link between consumer credit and bankruptcy than to understand what that link is. To say anything informative about the policy implications of the interaction, it is necessary to develop some factual premises about how one affects the other. Thus, it requires some understanding of the causative effects that run from borrowing to bankruptcy and from bankruptcy to borrowing.

#### 1. From Borrowing to Bankruptcy

At first glance, it seems odd to ask whether borrowing causes bankruptcy. Of course it does. How easy is it to become bankrupt without debt? The point here, however, is to understand the policy ramifications of the link between borrowing and bankruptcy. For example, assuming that there is an optimal level of bankruptcy and that current levels are hyperoptimal, why is it that the parties to lending transactions do such a poor job of estimating the risks of those transactions? It should be no surprise that I think the credit card is at least one of the major culprits,<sup>21</sup> and that the answer lies in the unusual trifurcated structure of credit card transactions (with separate points of agreement, purchase and borrowing).<sup>22</sup>

The separation of the three points in the credit card lending transaction hinders a borrower's assessment of the risks and returns of card transactions.

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20 Robert M. Lawless & Elizabeth Warren, *The Myth of the Disappearing Business Bankruptcy*, 93 Cal. L. Rev. 743 (2005).

21 Mortgage lending markets, in particular some newer home equity loan products, have many of the same structural characteristics as credit cards, and are likely contribute in similar ways to the excessive debt problem.

22 The structural problem exacerbates the misalignment of incentives between participants in lending markets and the cognitive defects that cause consumers to misestimate risks, both of which afflict consumer-lending markets in general.

The first point is the time of account opening — when the contract that will govern the borrowing is made. This point has little significance to the overall transaction, because the borrower has not made a decision to use the card.<sup>23</sup> The second point is the time of the purchase — when the decision to spend is made. The third point is the time of the monthly bill — when the decision to borrow is made. In this model, the crucial decision point is deferred at least until the time of the purchase. Therefore, it is difficult to countenance the assumption that contracting decisions rationally assess the risks and rewards of a particular borrowing transaction — the general foundation of the economic literature on consumer credit. That assumption does not map in any plausible way to the transactional structure of the dominant retail payment system in the American economy.

Structural considerations aside, the data bear out the idea that credit cards are unique contributors to the overindebtedness problem, an idea that is inconsistent with the claim that credit cards merely substitute for other less efficient forms of consumer lending. The data indicate that credit card debt correlates with subsequent increases in consumer bankruptcy, even when overall borrowing is held constant. Therefore, in a country in which the level of overall consumer borrowing remains constant, an increase of about \$100 per capita in annual credit card debt is associated with an increase in bankruptcy filings two years later of about 200 per million people.<sup>24</sup>

That problem might raise no substantial concern if borrowers and lenders were the only ones affected by excessive borrowing. It might reflect a value transfer from consumer borrowers to lenders, or a diversion of consumer resources toward the repayment of loans and away from investment or spending — indirect effects that would not justify broad policy responses. In fact, some claim that consumer credit contracts generate measurable externalities, at least when they lead to financial distress.<sup>25</sup> Thus, there is good reason for those designing regulatory policies for consumer credit

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23 As I discuss in a related paper, the dynamics of credit card contracting exacerbate the problem. Thus, even if it were rational for a borrower to study the contract, and even if the borrower evaluated the contract with perfect rationality, it would be difficult for the borrower to price the particular contracting and repayment terms, given the likelihood that the lender would change those terms in the future and apply the changed terms to outstanding borrowings. See Ronald J. Mann, "Contracting" for Credit, 104 Mich. L. Rev. 899 (2006).

24 See Ronald J. Mann, Charging Ahead: The Growth and Regulation of Payment Card Markets Around the World, ch. 5 (forthcoming 2006).

25 See, e.g., Jackson, *supra* note 8, at 1419-22; Eric Posner, *Contract Law in the Welfare State: A Defense of Usury Laws, the Unconscionability Doctrine, and Related Limitations on the Freedom to Contract*, 24 J. Legal Stud. 283 (1995).

markets and bankruptcy systems to account for the causative link between borrowing and bankruptcy.

## 2. *From Bankruptcy to Borrowing*

The converse question is the extent to which the existence of the bankruptcy system influences borrowing in the economy. On that point, the dominant models of consumer credit markets examine a world populated by omniscient and wholly rational actors. In that world, a loosening of bankruptcy standards — to make bankruptcy less rigorous or more readily available — would lead to an increased demand for borrowing. The central concern of those models is the resolution of the moral hazard problem. Thus, most scholars reason that rules that permit borrowers to display their repayment proclivities by accepting such remedies as arm-breaking, are important to allow signaling that can prevent markets from unraveling as more and more borrowers succumb to the moral hazard.<sup>26</sup> That concern is the subject of Part III. More pointedly for present purposes, many writers in the populist vein emphasize the possibility that a loosening of the rigors of bankruptcy might lead to opportunistic borrowing. Thus, they contend that consumers often borrow because they know that bankruptcy will forgive their obligation to repay the loan.<sup>27</sup>

Yet what we know about the reality of bankruptcy filers makes it difficult to credit the opportunistic-borrowing theory. First, the existing literature includes a rich series of research projects designed to collect evidence about the nature of the people that file for consumer bankruptcy in the United States. Although that literature is nuanced and does not always provide firm conclusions,<sup>28</sup> it does plainly suggest that the overwhelming majority of people that file for consumer bankruptcy in this country are in deep financial distress.<sup>29</sup> This suggests that the abusive and highly compensated filer, seeking

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26 Adler et al., *supra* note 6; Samuel A. Rea, Jr., *Arm-Breaking, Consumer Credit and Personal Bankruptcy*, 22 *Econ. Inquiry* 188 (1984); Richard Hynes, *Why (Consumer) Bankruptcy?*, 56 *Ala. L. Rev.* 121, 159-62 (2004).

27 E.g., Jones & Zywicki, *supra* note 2; Todd J. Zywicki, *An Economic Analysis of the Consumer Bankruptcy Crisis*, 99 *Nw. U. L. Rev.* 1463 (2005); *Bankruptcy Reform: Hearing Before the Senate Comm. on the Judiciary*, 109th Cong. (2005) (Testimony of Professor Todd J. Zywicki, Visiting Professor of Law, Georgetown University Law Center).

28 It is not clear, for example, whether older people suffer more or less in bankruptcy than younger people.

29 Teresa Sullivan et al., *As We Forgive Our Debtors* (1989) [hereinafter Sullivan et al., *As We Forgive*]; Sullivan et al., *supra* note 9; David U. Himmelstein et al.,

to discharge luxurious consumer spending, is largely a myth.<sup>30</sup> Surely, there are abusive cases, but there is little reason to think that they are sufficiently frequent to undermine the need for a broad discharge.

We also now have the empirical evidence from a comparative study of consumer credit, credit card debt, and consumer bankruptcy in about two-thirds of the world credit card market. If the opportunistic-borrowing theory were correct, we would expect to see a steep rise in credit card debt shortly before bankruptcy (i.e., in the six months immediately preceding the bankruptcy).<sup>31</sup> As bankruptcy grew closer, the causal connection between increases in credit card borrowing would grow more significant and display a substantially higher coefficient. As it happens, however, the evidence is contrary to that understanding. Rather, the evidence suggests that the relation between increases in borrowing and consumer bankruptcy plays out over a long period. This suggests a slow pattern in which consumers borrow ever farther beyond their means, leaving their financial position so fragile that they are unable to withstand the typical misfortunes so common in our global economy.

There is a distinct but related question about the relation between bankruptcy laws and bankruptcy filing rates. Although we would expect that a bankruptcy system that provides more relief would lead to more filings than one that provides less relief, we know little empirically about the fine details of that point. For example, although the Japanese are thought by some to be the most culturally averse to bankruptcy,<sup>32</sup> the Japanese bankruptcy filing rates are now higher than bankruptcy filing rates in Australia, and about the same as bankruptcy filing rates in Canada, apparently in response to the

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*MarketWatch: Illness and Injury as Contributors to Bankruptcy*, Health Aff., Feb. 2, 2005, at <http://content.healthaffairs.org/cgi/content/abstract/hlthaff.w5.63v1>; Katherine Porter & Deborah Thorne, *Going Broke and Staying Broke: The Realities of the Fresh Start in Chapter 7 Bankruptcies*, 92 Cornell L. Rev. (forthcoming 2006).

30 Lynn LoPucki provides a contrary account based on his experiences as a lawyer in consumer bankruptcy cases. See Lynn LoPucki, *Common Sense Consumer Bankruptcy*, 71 Am. Bankr. L.J. 461 (1997). The experiences he recounts, however, are difficult to reconcile with the empirical evidence with which I am familiar. There is some possibility that the reality of the system has changed since his experiences in practice, which did not extend into the period traced by the recent empirical evidence that Sullivan, Warren and Westbrook emphasize.

31 See Mann, *supra* note 24, ch. 5.

32 See Nathalie Martin, *The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation*, 28 B.C. Int'l & Comp. L. Rev. 1 (2005).

recently adopted westernized consumer bankruptcy system. But the important question of whether the higher filings result from the new system, as opposed to cultural or institutional developments, cannot be resolved without detailed statistical analysis that has not yet been undertaken in any country. Evidence from Canada, for instance, tends to suggest that debt levels have been much more important in the level of filings than anything else. Diane Ellis points out that bankruptcy filing rates in Canada rose quite rapidly after Visa entered the country's market for credit card lending. She compares that link to the similar rise in filings in the United States shortly after the deregulation of credit card interest rates. Her argument is that the increased filing rates in the US are more likely attributable to higher credit card debt than to the major changes in US bankruptcy law at about the same time.<sup>33</sup>

One of the hardest problems is defining "leniency" in this context. People commonly characterize the American consumer bankruptcy system as the most lenient, because of the immediate discharge that it offers. But when we add means-testing, broaden the categories of debts that are not dischargeable, and increase the period between permitted filings (all recent developments in US consumer bankruptcy practice), it becomes less clear that the practical effect of the system is more hospitable than a simpler system that grants a free and complete discharge to all after a short waiting period. It is even harder to assess the effect of the provisions that create administrative hurdles to filing (credit counseling, increased documentation, and lawyer certifications), which might limit filings by depriving potential filers of qualified advisers. Thus, any analysis that purports to predict the effects of any particular bankruptcy reform on filing rates must be met with at least some degree of skepticism.<sup>34</sup>

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- 33 Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate (1998)* (FDIC Bank Trends series), available at [http://www.fdic.gov/bank/analytical/bank/bt\\_9805.html](http://www.fdic.gov/bank/analytical/bank/bt_9805.html). I discount the argument of F.H. Buckley, *The American Fresh Start*, 4 S. Cal. Interdis. L.J. 67 (1994), because his comparative econometric analysis of the causes of US and Canadian bankruptcy filings includes no data on debt levels in the two countries.
- 34 The point is underscored by the conflicting empirical assessments of the effects of the Bankruptcy Code of 1978, 11 U.S.C. §§ 101-1330. Compare, e.g., Lawrence Shepherd, *Personal Failures and the Bankruptcy Reform Act of 1978*, 27 J.L. & Econ. 419 (1984) (finding a significant effect), with Jagdeep S. Bhandari & Lawrence A. Weiss, *The Increased Bankruptcy Filing Rate: An Historical Analysis*, 67 Am. Bankr. L.J. 1 (1993) (finding no significant effect). From my perspective, it would be surprising if we could find strong quantitative links between reform measures and filing rates, because so many external factors are likely to have much larger effects on filing rates. One such example, discussed in some detail in Part II, that is likely to undermine efforts to measure the effect of recent US bankruptcy reform

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In sum, the existing evidence casts doubt on the gravity of the concern that lax bankruptcy policy will lead to opportunistic borrowing and a subsequent unraveling or deterioration of the consumer credit markets. If anything, the data suggest, particularly with respect to entrepreneurial borrowing, that making discharge more accessible could have positive spillover effects by increasing the demand for activity most likely to have positive external effects.

## **B. On Stigma**

Views on the relation between the bankruptcy discharge and consumer economic activity are related to the problem of stigma, which has dominated academic and political debates about bankruptcy in the United States and elsewhere. Critics of the status quo claim that rising bankruptcy rates reflect a decline in moral fiber, evidenced by an undue readiness to accept relief in bankruptcy. Thus, the argument goes, there is a direct causal link between the improved public perception of bankrupts in the last few decades and the large-scale increase in the number of people who file for bankruptcy.

It is unfortunate that this point is treated as a serious subject for policy debate. First, as noted above, the empirical data that we have on this question points in one direction. Most filers in this country are in situations of such extreme distress that it is not plausible to view bankruptcy as a planning tool for them. Indeed, it is unlikely that any particular feature of the legal system (beyond the availability of an automatic stay) would have a notable effect on their decision to file. In other words, it is just as likely that such individuals would file even under a much more onerous system. Efforts to make the system less accessible only increase the costs to both the filers and to the taxpayers that fund the system.

In addition, only a small portion of the individuals who could file chooses to do so.<sup>35</sup> Because it is quite difficult to collect datasets of people that have not filed for bankruptcy but are in financial circumstances comparable to people

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legislation is the concurrent change to minimum payment requirements — a change that issuers expect to substantially alter bankruptcy filing rates.

35 See Michelle J. White, *Why It Pays to File for Bankruptcy: A Critical Look at Incentives Under US Bankruptcy Laws and a Proposal for Change*, 65 U. Chi. L. Rev. 685 (1998) [hereinafter White, *Why It Pays*]; Michelle J. White, *Why Don't More Households File for Bankruptcy?*, 14 J.L. Econ. & Org. 205 (1998) [hereinafter White, *Why Don't More Households File?*].

who do file, we know little or nothing about precisely what motivates particular individuals to file. Without such data, it is difficult to credit the simplistic notion that the lack of stigma from bankruptcy is generally motivating them. If the decline in stigma is a general societal problem, why doesn't stigma motivate the millions of other similarly situated nonfilers?

Third, the studies suggesting that a decline in stigma has accounted for much of the filing surge since the enactment of the 1978 legislation are methodologically unsound. The general technique of the existing studies has been to proceed by the circuitous route of identifying various other institutional reasons for filing changes, treating stigma as the cause of all remaining unexplained variation in filing rates.<sup>36</sup> Others use crude proxies for strength of social norms (measured, for example, by urban residency, Catholicism, and age).<sup>37</sup>

For example, the most widely discussed paper is a 2002 study by David Gross and Nicholas S. Souleles.<sup>38</sup> Their study uses a proprietary dataset of account information obtained from credit card issuers to track the "propensity to default" of particular cardholders. Taking account of the information in their dataset, their model explains about 13% of the variation in default rates, but suggests relationships on the basis of which they conclude that there was a significant increase in the propensity to default — a decline in stigma — between 1995 and 1997. My skepticism arises first from the oddity of the empirical conclusion — why should that particular biennium be the locus of a change in social perception we would expect to play out over decades? Turning to the analysis, the basic problem with the methodology is that, even taken on its own terms, it cannot possibly identify any share of filings attributable to a decline in the sense of the filers that their conduct is shameful, because that methodology cannot disentangle that effect from other closely related effects.

Moreover, the studies do not even do a credible job of including the

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36 E.g., Scott Fay et al., *The Household Bankruptcy Decision*, 92 Am. Econ. Rev. 706 (2002); David B. Gross & Nicholas S. Souleles, *An Empirical Analysis of Personal Bankruptcy and Delinquency*, 15 Rev. Fin. Stud. 319 (2002).

37 See F.H. Buckley & Margaret F. Brinig, *The Bankruptcy Puzzle*, 27 J. Legal Stud. 187 (1998). The argument of that paper is that correlations between lower bankruptcy filings and greater population shares of urban residents, Catholics, and the elderly indicate that bankruptcy filings are a sign of the breakdown of social networks. In one of the articles in this volume, Rafael Efrat ingeniously tries to measure stigma by studying references to bankrupts in the *New York Times*. He finds insufficient evidence to conclude that changes in perception prompted increased bankruptcy filings. Rafael Efrat, *The Evolution of Bankruptcy Stigma*, 7 Theoretical Inquiries L. 365 (2006).

38 Gross & Souleles, *supra* note 36.

plausible variables that might explain bankruptcy filings. Thus, the most obvious thing to me about the Gross and Souleles study is that their lengthy list of variables does not directly account for the outstanding amount of credit card debt.<sup>39</sup> The same problem afflicts the entire body of literature on the subject.<sup>40</sup> A relatively simple model with variables for changes in GDP, credit card debt, credit card spending, and consumer credit has a much better fit to a much less homogenous dataset — my model explains more than 90% of the variation in bankruptcy filing rates in a dataset from six different countries — even though it has many fewer data points.

More broadly, it is difficult to see how any such study, however carefully designed, could separate the effect of stigma from a "learning-curve" effect associated with increased awareness of the bankruptcy process. It is plain that consumer bankruptcy filings increase with increases in consumer debt. As filings increase, the average person might be more aware of the bankruptcy process and view it more charitably. Some of the change might simply be attributable to an accurate understanding of the process. Yet at the same time, increased awareness might cause some to fear bankruptcy filing even more than they did before. More importantly, it is quite difficult to connect the effects of increased awareness with actual filing patterns. The increased awareness is likely to affect a large number of people, of whom only a small number choose to file.

Finally, and most fundamentally, the acceptance of a stigma lever as a policy tool has unpleasant consequences, which seem perverse in light of the sociological literature and commonsense understandings of the negative effects of stigma. If we credit the possibility that even a substantial number of the current bankruptcy filers are forced into filing by exogenous circumstances that few could surmount, exactly what are we trying to accomplish by increasing the sense of shame and blameworthiness we wish them to attach to their actions? Would we deal with the fallout of one-parent households by increasing the stigma of divorce?<sup>41</sup> As Mark West shows in

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39 Because their dataset does include two different credit scores for each borrower, it is possible that information about outstanding borrowing is indirectly accounted for (because it is likely to affect the credit score). Nothing in the paper, however, discusses whether that is true or how the variables they do use are likely to relate to credit card use.

40 Cf. Buckley & Brinig, *supra* note 37 (expressing doubt that lending variables could explain the variation and noting that they did not use lending data in their models); Buckley, *supra* note 33 (econometric model designed to test differences between Canadian and American filing rates that does not include any data related to debt in the two countries).

41 Jones and Zywicki apparently would. See Jones & Zywicki, *supra* note 2, at



his discussion of Japanese who use suicide to avoid the shame of financial insolvency, there are ways of responding to financial distress that have greater social cost than a bankruptcy filing.<sup>42</sup> In the end, we don't *really* want to live in a society where people, like Sir Walter Scott, elevate their repayment obligations to a life-or-death question.

## II. REGULATING CONSUMER CREDIT MARKETS

With the empirical perspective in hand, I turn now to a concrete discussion of the relevant regulatory problems. When we think about the regulation of consumer credit markets, we must start with the reality that most credit transactions are value-increasing transactions for all parties. Notwithstanding the relation between an increase in borrowing and an increase in financial distress, it remains true that the overwhelming majority of borrowers successfully repay their debts. Lenders in free markets presumably profit from most of these transactions, and borrowers presumably profit from almost all of them. (They would profit from all of them if it were not for the likelihood that some borrowing transactions reflect poor judgment even if the borrower ultimately obtains the funds to repay the loan.)

Moreover, many transactions will be valuable not only for the parties that participate in them, but for third parties as well. They will generate positive externalities, as the expenditures will indirectly support the manufacturing and service sectors of the economy. Thus, as discussed in Part I, there is some reason to expect a positive relationship between increases in household indebtedness at one point in time and consumer expenditures and gross domestic product some years later. The goal, then, is to identify policies that burden the transactions most likely to impose costs on the rest

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217 (treating the decline of the stigma of divorce and bankruptcy as parallel social problems). On the contrary, most scholars who have studied the question from a family-law perspective have concluded that the decline of stigma has the positive effect of lessening the trauma of divorce. *E.g.*, Anita Bernstein, *For and Against Marriage: A Revision*, 102 Mich. L. Rev. 129, 194-95 (2003); Amy L. Wax, *Bargaining in the Shadow of the Market: Is There a Future for Egalitarian Marriage?*, 84 Va. L. Rev. 509, 668 (1998). For empirical support, consider Paul Amato's research on the effect of divorce on children. He suggests that efforts to reduce the stigma of divorce have limited the harm divorce creates for the children of divorcing parents. Paul R. Amato, *Life-Span Adjustment of Children to Their Parents' Divorce*, 4 *Future Child*. 143 (1994).

42 Mark D. West, *Law in Everyday Japan: Sex, Sumo, Suicide, and Statutes 215-65* (2005).

of society, without imposing hurdles on the value-increasing transactions that reflect the bulk of consumer expenditures and borrowing.

It is likely that some of the instrument-induced risk could be managed through reforms that shift payment transactions away from credit cards to other electronic payment systems such as debit cards.<sup>43</sup> It might seem odd to think that a shift from credit cards to debit cards would have a substantial effect on prodigal expenditure and borrowing, but the data suggest that it would. The correlations between increased credit card use and increases in consumer credit, for example, largely dissipate if overall plastic card use is substituted as the explanatory variable. When we recall the reasons for rising debit card use in the United States — the most plausible being a quasi-rational precommitment to enforced budgeting — the data is easier to understand.

Still, what we see from the UK — where credit card use as a share of plastic card use has remained small — is that a fully developed economy can develop a consumer debt load of troubling proportions even where debit cards are used to a much greater extent than they are in the United States.<sup>44</sup> Indeed, the UK is not alone. Many of the countries with the most serious problems with burgeoning consumer credit are not countries in which the credit card has yet taken hold. Thus, although payment systems reform might do a great deal, especially in countries where credit cards are dominant, further steps to control the social costs of excessive borrowing are likely to be appropriate in most cases.

### A. Usury Regulations

The most common regulatory response to the problems that afflict consumer credit markets has been formal price controls: a so-called "usury" statute that would bar transactions above specific prices. Therefore, for example, recent years have seen one version or another of that approach from academics of such widely varying perspectives as Elizabeth Warren, Eric Posner, and Christopher Peterson.<sup>45</sup>

As a structural matter, the usury proposals confront two foundational

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<sup>43</sup> See Mann, *supra* note 24, chs. 13-14.

<sup>44</sup> In the UK, a disproportionately large amount of the debt is in the form of home mortgages. For general discussion of the problem, see The Griffiths Commission on Personal Debt, *What Price Credit?* (2005), available at <http://www.niace.org.uk/news/Docs/Griffiths-report-on-personal-debt.pdf> [hereinafter Griffiths Commission, 2005 Report].

<sup>45</sup> Elizabeth Warren & Amelia Warren Tyagi, *The Two-Income Trap: Why Middle-Class Mothers and Fathers Are Broke* (2003); Posner, *supra* note 25; Christopher

difficulties. The first is the acknowledged bluntness of usury as a tool to respond to social problems.<sup>46</sup> The different proponents of usury proposals have different concerns. Posner is concerned about the externalities that risky credit transactions impose through increasing the cost of the welfare system. Warren is concerned about the likelihood that the lending often reflects poor judgment on the part of those that engage in it. In any case, however, the concern is not simply that the rate is high. The concept in each case is that high interest rates are a useful proxy for the types of transactions that would justify market intervention.

There is little reason to think, however, that high interest rates are a particularly good proxy for any of the underlying concerns. Thus, any usury limitation necessarily will be both over— and under-inclusive. Indeed, Posner recognizes this problem specifically. His model recognizes that the limitation he proposes would forbid some transactions that are value-increasing — risky but not prodigal transactions for which a high rate of interest is appropriate — and permit some transactions that impose externalities — prodigal borrowing that occurs at rates below the usury cap. Because borrowers and the uses that they make of funds are so heterogeneous, the bluntness of the tool is a serious problem. Even an omniscient regulator could not easily define a usury limit that would produce optimal benefits, so we should be reluctant to expect that the conflicting interests that could motivate legislative action would lead to anything that approximates a plausible level.

The bluntness problem is aggravated by the rapid segmentation of the consumer borrowing market. Even fifteen years ago, credit card issuers charged borrowers in their portfolios one of a small number of rates, with very few distinctions based on the relative creditworthiness of different customers in the portfolio. The lesson of the last ten years, however, is that information technology makes it much easier to loan larger amounts of money more reliably to individuals with less extensive and less positive credit histories. This has resulted in an increasingly sophisticated differentiation among borrowers, in which borrowers of different risks pay cognizably different rates of interest, resulting in the kind of segmentation that is thought to be beneficial to the market.<sup>47</sup> Indeed, segmentation generally has

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L. Peterson, *Taming the Sharks: Towards a Cure for the High Cost Credit Market* (2004).

<sup>46</sup> James J. White, *The Usury Trompe L'Oeil*, 51 S.C. L. Rev. 445 (2000) (making this point in some detail).

<sup>47</sup> Mark Furletti, *Credit Card Pricing Developments and Their Disclosure* (January 2003) (Fed. Res. Bank of Philadelphia, Payment Cards Center, Discussion Paper),

led to a decline in the effective interest rate charged on outstanding credit card debt.

To be sure, the rate of default on high interest loans is likely to be higher than the rate of defaults on a set of loans to persons of uniformly higher creditworthiness. Yet that says little about whether the transactions are so risky as to justify prohibiting them. What remains plain is that a usury regulation is not well-designed to sort the undesirable transactions from the desirable ones.

Another major problem that any usury regulation must confront is the distortion it will impose on the credit market. The discussion above explains why a usury regulation will impose costs even if borrowers and lenders take no actions to avoid the application of the regulation. In fact, however, a usury regulation is likely to lead not only to the suppression of some transactions that impose externalities, but to the shifting of a substantial portion of the proscribed transactions either to markets that are beyond the scope of the regulation or to extralegal markets beyond the scope of any regulation. For one thing, what little evidence we have suggests that the demand for credit is remarkably stable even across national, cultural, and regulatory boundaries. Therefore, low— and middle-income consumers have similar needs for credit everywhere, and regulatory constraints will not change that.<sup>48</sup> Because in practice usury regulations apply differentially and haphazardly to the highly segmented menu of consumer credit products, the potential for shifting among products — which might at first glance seem a trivial detail — is in fact a serious problem.<sup>49</sup>

The evidence is surprisingly varied. In Japan, for example, restrictions that have prevented banks from issuing revolving credit have led to a marginal decline in the amount of credit, because of market shifts to lenders that are not as well-situated as banks.<sup>50</sup> Nevertheless, it is also fair to think that the regulations have led to a much larger shift in lending to relatively unregulated nonbank consumer lenders (the *sarakin* and *yenya* of the Japanese news media). Thus, the most notable effect of the prohibition has been to shift borrowers from the most heavily regulated and responsible lenders to the least regulated and responsible.<sup>51</sup> To be sure, if one believed

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available at <http://www.phil.frb.org/pcc/discussion/discussion0103.pdf>. For similar analysis of events in the UK and France, see Department of Trade and Industry, *The Effect of Interest Rate Controls in Other Countries* (2004) [hereinafter DTI Report].

48 DTI Report, *supra* note 47.

49 See White, *supra* note 46.

50 See Ronald J. Mann, *Credit Cards and Debit Cards in the United States and Japan*, 55 Vand. L. Rev. 1055 (2002).

51 See Ronald J. Mann, *Regulating Internet Payment Intermediaries*, 82 Tex. L. Rev.

existing insolvency procedures to be systematically too lenient, then a system that permitted people to opt into harsher procedures that involved corporal abuse or imprisonment could be optimal.<sup>52</sup> Although I am convinced of the value of harsh sanctions in the commercial context, I am willing to assume that in all of the important commercial nations (even the United States), the rigors of consumer bankruptcy as it currently exists are sufficient to make recourse to extralegal enforcement mechanisms suboptimal.

Similarly, American historians suggest that one of the main reasons regulators pushed for banks to enter the consumer credit market in the 1920s was to shift consumer lending from smaller and less reputable lenders to banks, which were thought to be kinder, gentler, and more reliable conduits for this activity.<sup>53</sup> More recently, empirical evidence about market shifts at the time of credit card rate deregulation in the United States in the early 1980s shows significantly different rates of shifting from finance companies to credit card lenders based on the nature of rate regulation.<sup>54</sup> Finally, the history of consumer mortgage lending in both Canada and the UK shows that regulations that permit (or prohibit) banks from issuing consumer mortgages at market rates can cause massive shifts of market share to and from banks.<sup>55</sup>

The link between credit card borrowing and financial distress might suggest that a shift of borrowing from credit cards to other loan products would be beneficial. I think, however, that a shift induced by a low interest rate limit (in the range of 18%) in fact would be detrimental. Such a shift would drive the consumer loan market to less efficient products (bank lines, factors, and the like). Accordingly, I find the shifting problem a serious obstacle to aggressive usury regulation.

One possible response would be to solve the problem by adopting a much broader usury regulation. In Japan, for example, if regulators wished to restrict credit entirely rather than simply allocate the profitable lending to

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681 (2004) (discussing benefits of keeping consumer transactions in the hands of banks rather than smaller and less reputationally constrained entities).

52 For the classic model of the demand for extralegal enforcement of consumer credit contracts, see Rea, *supra* note 26. In his model, the problem is moral hazard; borrowers agree to harsh consequences for revealing their intentions to repay.

53 See Harold van B. Cleveland, *Citibank: 1812-1970* (1986); James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* (1992).

54 Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 *Yale J. on Reg.* 201 (1986).

55 See Margaret Ackrill & Leslie Hannah, *Barclay's: The Business of Banking 1690-1996*, at 188-89 (2001); Duncan McDowall, *Quick to the Frontier: Canada's Royal Bank* (1993).

finance companies, they could apply usury limits without exceptions, so that all kinds of lending transactions would be covered. It is not clear, of course, what effect that would have on lending that depends explicitly on extralegal methods of enforcement, a market that experience suggests will be significant wherever usury laws constrain legal markets significantly.

More practically, the heterogeneity of consumer credit products and markets makes it likely that any broad-brush response would run headlong into the bluntness problem discussed above. For example, market interest rates on payday loans in the United States commonly are in the range of 500%.<sup>56</sup> We might accept the fact that a risk premium would justify doubling or tripling the rate that a creditworthy borrower would pay, but rates like these — dozens of multiples of market rates — at first glance suggest a wholly abusive market. The difficulty, however, is that an obvious reason for some elevation of rates is the relatively small size of the transactions in question. If we suppose that there are fixed costs in administering any lending transaction,<sup>57</sup> then as the size of the transaction approaches zero, the rate that would cover the cost of funds, risk of loss, and transaction costs would become asymptotically high.

I do not intend to suggest that the markets for payday lending are well-functioning or that the rates are low. I do think, however, that the rise of publicly traded payday lenders suggests that the market is becoming much more competitive, at least in jurisdictions that have usury ceilings sufficiently high to permit the firms to operate profitably.<sup>58</sup> What little comparative evidence we have (government reports issued in the UK in the last few years) suggests that consumers respond quite rationally to the differences in major lending products available to them.<sup>59</sup> Predictably enough, the evidence shows that consumers perceive there to be a spectrum from relatively disadvantageous products (like rent-to-own suppliers and pawnbrokers, where consumers risk losing their tangible property) to relatively benevolent products (like payday loans, where the risks are "only" financial). A comparative study of current markets suggests, as you might expect, that consumers use the relatively disadvantageous products

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<sup>56</sup> See Peterson, *supra* note 45.

<sup>57</sup> DeMuth, *supra* note 54, at 228, reports a Federal Reserve study indicating that about 60% of the costs of consumer lending are administrative costs unrelated to the cost of funds. For a detailed discussion of this problem in the UK, see Griffiths Commission, 2005 Report, *supra* note 44.

<sup>58</sup> See Robert Elder, *Payday Lenders Banking on New State Law*, Austin American Statesman, Apr. 22, 2005, available at <http://www.statesman.com/search/content/business/stories/03/22payday.html>.

<sup>59</sup> DTI Report, *supra* note 47; Griffiths Commission, 2005 Report, *supra* note 44.

only in areas in which regulatory authorities have foreclosed opportunities for the relatively benevolent ones.<sup>60</sup> Thus, we might think, for example, that rules sufficiently relaxing restrictions in order to permit a competitive market for payday lenders ultimately would benefit consumers by giving them a sufficient supply in that market to forestall their use of more onerous rent-to-own products.<sup>61</sup>

The point of this discussion is to suggest that regulators will need to have a sophisticated sense of the on the ground value and cost structure of the various products that they are regulating to design usury regulations that will not be counterproductive. The difficulty of that problem convinces me that the bluntness implications of any sensible set of ceilings are serious.<sup>62</sup> This is not to say that a high ceiling might not be appropriate. Such a ceiling would have the salutary effect of prohibiting transactions at rates sufficiently high to suggest a lack of engaged consent by the borrower. Thus, they might have a targeted effect on various classes of subprime lending markets. They would not, however, provide a substantial response to the overindebtedness problem.

## **B. Minimum Payments**

Another approach would be to impose rules requiring certain types of lenders to insist upon a minimum payment amount each month. For example, Britain formerly had a rule requiring cardholders to repay 15% of their credit card debt each month.<sup>63</sup> Even American regulators, acting through the Federal Financial Institutions Examination Council (an interagency group

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<sup>60</sup> See DTI Report, *supra* note 47.

<sup>61</sup> For a recent and thorough discussion of the systemic problems in providing financial services to the poor, see Michael Barr, *Banking the Poor*, 21 Yale J. on Reg. 121 (2004).

<sup>62</sup> UK policymakers in the last few years have rejected interest rate caps after a series of detailed studies of subprime lending markets convinced most of those involved that caps would do more harm than good. DTI Report, *supra* note 47; Griffiths Commission, 2005 Report, *supra* note 44.

<sup>63</sup> See Ackrill & Hannah, *supra* note 55, at 188-89; *The Plastic-Money Would-Be Pre-Election Boom*, *Economist*, Sept. 9, 1978, at 107 (discussing a rule imposed in 1973 and lifted in 1978). Similarly, in the context of hire purchase agreements (roughly equivalent to retail installment sales in the United States), the UK and other Commonwealth countries have had a long tradition of imposing minimum down payments and maximum repayment terms. See R.M. Goode & Jacob S. Ziegel, *Hire-Purchase and Conditional Sale: A Comparative Survey of Commonwealth and American Law* 237-44 (1965).

that oversees standards for federal examination of financial institutions), have issued recent "guidance" suggesting that lenders should not permit negative amortization and should require repayment in a "reasonable" time.<sup>64</sup> Although targeted primarily to the subprime lending market, the annual reports of major American card issuers suggest that the guidance has had an important effect even on mainstream lending practices.<sup>65</sup>

One systematic advantage of this approach is that it does not directly prohibit any value-increasing transaction. Borrowers that believe they can use funds in ways that justify payment of the market interest rates are free to borrow the funds from lenders that believe the borrowers are sufficiently creditworthy. Of course, the likelihood that minimum payment requirements would not be catastrophic does not say much about whether they would be beneficial. Although I am not convinced the proposals would make a major change, they do seem to me reasonably likely to be beneficial for two interrelated reasons.

First, there is some likelihood that people in financial distress will not be able to make the payments and thus will default and fall into bankruptcy sooner rather than later. This would be beneficial if consumer borrowers often defer bankruptcy filings too long. If we can cause lenders to cut the borrowers off sooner, the externalities of financial distress will diminish. Although the lender does lose something in each case in which the borrower does not repay, we cannot rely on the lender to make the appropriate judgment because the lender does not bear all of the losses of the customer's financial distress. Third parties bear a substantial portion of the losses, giving

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<sup>64</sup> The Federal Reserve press release is available at <http://www.federalreserve.gov/boarddocs/press/bcreg/2003/20030108/> (Jan. 8, 2003).

<sup>65</sup> MBNA reports, for example, that it has changed its standard procedure from requiring a repayment of 2.25% of the borrower's total debt (a shade above the interest accruing at 18% each month) to a requirement that each borrower repay 1% of the principal each month in addition to all interest and fees. This is not a requirement that each borrower repay its bill in 100 months. As described in the annual report, a borrower that made the minimum payments under that plan, and never made any future purchases, would never repay the outstanding debt, because the minimum payment would decline steadily as the outstanding balance declined. See MBNA, 2004 Annual Report 33 (2005). The requirement is expected to reduce the interest income available to issuers, which may cause issuers to raise fees. See Tom Ramstack, *Fees Put Squeeze on Credit Cards*, Washington Times, July 4, 2005, available at <http://washtimes.com/business/20050704-121132-3645r.htm> (attributing recent fee increases of US Bank and JPMorgan Chase to increased minimum payment requirement).



the lender inadequate incentive to set payment plans that will minimize the total costs of financial distress.

The second effect is less objective and certainly is related to the first, but focuses more on the nature of the loan that is being extended. When lenders extend closed-end installment loans to fund the purchase of specific commodities, they generally set repayment schedules that mirror the useful life of the subject property. The lending and purchase go hand in hand in disciplining the borrower's adherence to a budget that matches expenditures (on loan repayments) with the borrower's enjoyment of the useful life of the object.<sup>66</sup> When the loan is extended for daily purchases, the enjoyment of which is completed in days or weeks, with repayment deferred for months or decades, we have created a loan that bears no relation to the useful life of the purchases.

This is not the place, and I am not the writer, to examine all of the implications of that shift. Yet one relevant implication certainly is the possibility that such loans will have a systematically higher likelihood of default. If that is so, the loans may be more likely to produce social costs than more conventional loans. A natural minimalist response, then, might be to adopt a rule that open-ended lending must have repayment schedules that, at the outside, would amortize a loan within 60 months (the long end of the typical range of fully amortizing loans for personal property).

It is difficult to predict whether such a rule would have important effects. But the early evidence suggests that even the weak guidance recently issued by American regulators has had cognizable market effects parallel to the ones that I discuss.<sup>67</sup> In sum, this reform would not solve the problem. But if existing business models involve substantial lending to borrowers in distress, such a reform could have a substantial positive effect.

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<sup>66</sup> This is the point of the "budgetism" that is a prominent theme in Lendol Calder, *Financing the American Dream: A Cultural History of Secured Credit* (1999).

<sup>67</sup> See, e.g., Bank of America, 2004 Annual Report 30, 35, 43, 69 (2005) (noting an increase in chargeoffs and provisions for losses on credit card lending because of the change); Citigroup, 2004 Annual Report 55 (2005) (predicting increased losses and delinquencies because of the change); JPMorgan Chase, 2004 Annual Report 21 (2005) (predicting that the change will cause increased delinquency and chargeoff rates); *MBNA Profits Plunge Among Record Results for US Banks*, 337 *Cards Int'l*, Apr. 29, 2005 (reporting 94% decline in profits for MBNA, apparently related to higher minimum-payment obligations). As other lenders raise their required payment levels, the costs should spread. See Tom Ramstack, *Fees Put Squeeze on Credit Cards*, *Washington Times*, July 4, 2005 (predicting that CitiBank, Bank of America, and MBNA would raise their minimum payment levels to 4%).

### C. Taxing Distressed Debt

The discussion above leads naturally to a more targeted solution: a tax on distressed debt — in particular a tax that credit card issuers would pay based on the amount of defaulted credit card obligations owed to them.<sup>68</sup> A tax that is imposed on debt that has gone into default is much more carefully tailored to the transactions that are likely to impose externalities than a usury regulation. It will not cover any transaction in which the benefits that the borrower receives from the lending transaction turn out to be adequate to facilitate repayment.<sup>69</sup> And it responds to the problem more directly than an alteration in minimum payment requirements, because it directly places upon one of the parties to the transaction some of the costs that the transaction currently shifts to nonparties.

To the extent that a tax increases the ex ante price of credit in the relative markets, that seems to me an appropriate outcome. Given the rapidly developing segmentation of risk pools, we would expect a tax to lead to a surcharge of varying sizes based on the anticipated riskiness of the borrower. High quality (high FICO score<sup>70</sup>) borrowers would pay little or no surcharge; low quality (low FICO score) borrowers would pay a much higher surcharge.<sup>71</sup> From a broader perspective, a surcharge is simply a shift between the parties to the transaction of the costs that they are presently jointly externalizing.

To be sure, the tax is likely to cause a contraction of lending to distressed borrowers, as credit card issuers attempt to avoid growth in their portfolio of distressed debt, or an acceleration of the time when distressed borrowers file for bankruptcy. For reasons discussed above, I find both of those outcomes appealing. For one thing, it is easy to see transactions foregone under a tax

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68 This idea is derived from a tax on defaulted credit obligations that is part of the new Belgian bankruptcy system. See Kilborn, *Belgium and Luxemburg*, *supra* note 9.

69 This tax also has the important benefit that it probably could be applied to national banks without risk of preemption or evasion under the National Bank Act, something that is not true for usury regulations. Mark Furletti, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards*, 77 Temp. L. Rev. 425 (2004).

70 The "FICO" score is the credit score commonly used to assess the creditworthiness of American borrowers. The term is a registered trademark of FairIsaac, the company that originated the algorithm for calculating the scores.

71 I use that specific example of segmentation because Furletti's data indicate that segmentation of borrowing pools by FICO scores provides a useful benchmark for the rapidly increasing differentiation of interest rates within a single creditor's portfolio. Furletti, *supra* note 47.

as transactions that go forward now only because a portion of their risks are shifted to third parties; there is no point to internalizing the risk if the tax is not going to limit some of the externality-generating transactions. More broadly, as discussed above, the contraction of lending would cause borrowers to file for bankruptcy earlier in their downward spiral. The dominant consensus within the literature that has examined empirical data about the condition of consumer borrowers by the time they file for bankruptcy is that the existing system generally causes consumer borrowers to file for bankruptcy too late, when an earlier filing might have solved problems with lower total costs. A tax that responds to that problem effectively would be salutary.

### III. CONSUMER BANKRUPTCY REFORM

From one perspective, it makes no sense to view consumer bankruptcy policy as a completely separate topic. If the bankruptcy system is part of the social safety net, then we should think about bankruptcy policy alongside health-care policy, insurance policy, entrepreneurial policy, and the like.<sup>72</sup> Recognizing that there is some truth to that point in an ideal world, it continues to be the case that bankruptcy policy is in fact made against the backdrop of its relation to the consumer finance markets. Thus, this Article considers bankruptcy policy in relative isolation, as it relates to the finance markets. As the discussion below suggests, my view is that much work remains to be done in analyzing policy issues even in that relatively confined milieu. If we could produce a sound understanding of bankruptcy policy as it relates to the finance markets, then that understanding could form the basis for considering the extent to which other major policy imperatives (like health care and social security) would influence (or be influenced by) the reality of bankruptcy and financial distress.

When we come to bankruptcy rules as a policy lever for minimizing the social costs of excessive borrowing, we confront a substantial body of economics literature about what type of discharge would have the optimal effect on credit markets. The general problem is that bankruptcy law must balance the protection of creditors, which promotes the availability and inexpensive provision of credit, against the protection of debtors, which prevents overindebtedness and underscreening by banks. Thus, strong legal

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<sup>72</sup> The original source on that point as a matter of theory is Jackson, *supra* note 8. For a broader discussion founded on empirical investigation, see Sullivan et al., *supra* note 9.

protection of creditors may be efficient *ex ante*, but create inefficiencies *ex post*. For example, Tom Jackson argued two decades ago that basic economic principles called for a relatively unhindered fresh start to prevent the losses society bears when individuals become irretrievably enmeshed in financial distress.<sup>73</sup>

Recent literature has focused on various ways in which a less generous bankruptcy system might improve the incentives of consumer borrowers. The Adler-Polak-Schwartz (APS) model, for example, suggests that an optimal market would solve moral hazard problems by permitting consumer borrowers to waive their bankruptcy remedies by contract.<sup>74</sup> Similarly, much of Michelle White's research has at least implicitly suggested that exemptions that preserve any substantial asset base for consumer bankrupts will give consumers incentives to file for bankruptcy without adequate financial distress to justify the discharge that they will receive.<sup>75</sup>

Read with care, that work provides little support for increasing the rigor of the bankruptcy system. Most obviously, the APS model specifically assumes that the parties to a borrowing transaction internalize all costs of financial distress. Essentially, their paper suggests that we should permit contracting out of bankruptcy because in a world where bankruptcy is partly endogenous — within the borrower's control — contracting will allow borrowers to sort themselves and precommit to avoid moral hazard. Obviously, if bankruptcy is largely exogenous or attributable in part to quasi-rational behavior, as I argue above, then the significance of this effect fades. Again, what we know about the reality of bankruptcy in the United States<sup>76</sup> and in the UK<sup>77</sup> suggests that a great deal, if not the overwhelming majority, of bankruptcy is exogenous. Similarly, as discussed above, Michelle White's own work suggests a variety

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73 Jackson, *supra* note 8.

74 Adler et al., *supra* note 6.

75 See White, *Why It Pays*, *supra* note 35; White, *Why Don't More Households File?*, *supra* note 35.

76 The basic argument of the work of Sullivan, Warren & Westbrook generally is that bankruptcy for the most part is exogenous. *E.g.*, Sullivan et al., *As We Forgive*, *supra* note 29; Sullivan et al., *supra* note 9; Warren & Tyagi, *supra* note 45.

77 The Griffiths Commission Report argues that consumer bankruptcy in the UK (where total household indebtedness is even higher than it is in the United States) generally follows a "trigger" (such as loss of a job or change in family circumstances) followed by a "spiral" into debt that cannot be repaid. Griffiths Commission, 2005 Report, *supra* note 44. The Griffiths Commission Report is particularly interesting because it offers a rare glance at what seems to be reliable household-level information about consumer credit, helping us to understand into how small a share of the nation's households the average amount of outstanding credit is compacted.

of empirical scenarios in which it would be counterproductive to lower the ability of bankrupts to protect post-bankruptcy earnings.<sup>78</sup>

It is important, however, to think about the problem more broadly. Explicitly or implicitly, all of the existing literature rests on the assumption that borrowers are better situated than lenders to avoid financial distress and bankruptcy.<sup>79</sup> That view might have made sense in a traditional bank lending model, where a borrower comes to a bank, sits in the banker's office, executes loan documents, receives funds, and is then free to go — unconstrained in any realistic way from later activities that might reduce the likelihood that the borrower would be able to repay the loan. In the traditional bank lending model, for example, the bank is unable effectively to prevent the borrower from engaging in reckless future borrowing or wasting the borrowed funds on frivolous luxuries.

In the modern information-based lending world, however, it makes less sense to view borrowers as operating in full control to the detriment of hapless and incapable lenders. Most obviously, the modern lender (at least in the United States) has access to pervasive and frequently updated information about the credit behavior of its customers.<sup>80</sup> For example, the modern credit card lender has the ability to terminate the borrower's use of funds at any time by the simple expedient of refusing to permit additional uses of the card once the information available to the lender indicates that the borrower is insufficiently creditworthy. On that point, the rise of credit bureaus largely has solved the problem of multiple nonadjusting lenders harming each other's prospects without any particular one being aware of the others.

In sum, in the modern world illustrated in Figure 1, particularly in the context of credit card lending, the rate of default in a lender's portfolio is largely within the control of the lender. If a lender wishes to lower the rate of default in its portfolio, it can simply tighten the criteria it uses for determining when to cease advancing credit.<sup>81</sup> Of course, tightening might

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78 White, *supra* note 7.

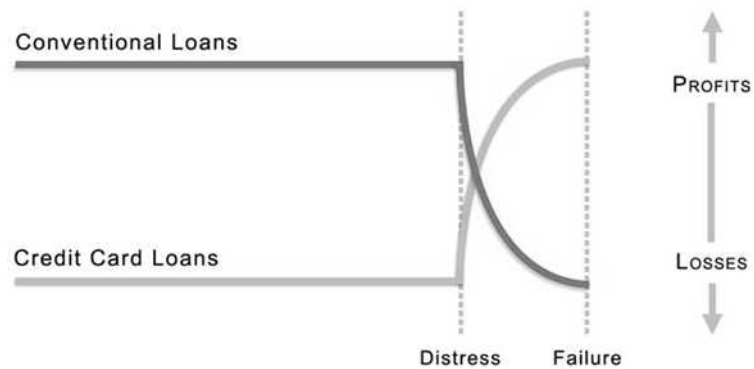
79 E.g., Jackson, *supra* note 8; Adler et al., *supra* note 6.

80 The idea is not a new one. For example, writing in 1985, Jackson presciently acknowledged the possibility that experienced lenders might develop the ability to monitor borrowing more adeptly than borrowers. Jackson, *supra* note 8, at 1400; see Theodore Eisenberg, *Bankruptcy Law in Perspective*, 28 UCLA L. Rev. 953, 976-91 (1981).

81 As a glance at any annual report for a monoline credit card issuer will show, this is an oversimplification. Delinquencies on credit card accounts show a distinct time trend as the portfolio ages, as much of the science of managing delinquency and charge-off rates involves management over time of classes of accounts of differing ages and risk profiles. See, for example, Providian's discussion of its carefully

not be profitable if it lowers the revenue the lender gains from loans to risky borrowers. Yet all that means is that modern lenders are optimizing the default rates in their own portfolios — balancing default losses against profits from loans to less creditworthy potential consumers.<sup>82</sup>

**Figure 1**  
The Dynamics of Profitability



Once we recognize that lenders are optimizing the risk of default from a private perspective that takes no account of the externalities that financial distress leaves to be borne by third parties, we have a problem that warrants the attention of policymakers. A glance at some illustrative statistics about the credit card industry will be useful. Under the conventional model, increasing delinquency rates by cardholders translates directly into a loss for the card issuers, which translates directly into increased charges borne by the cardholders who repay.<sup>83</sup>

In a world in which lenders are optimizing default rates and externalizing losses to other parties, increased delinquency rates do not necessarily suggest that lenders should raise prices and lower output. On the contrary, to the

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implemented efforts to lower the delinquency rate in its portfolio since 2001 by shifting to higher quality borrowers. Provident, 2004 Annual Report 3-5 (2005).

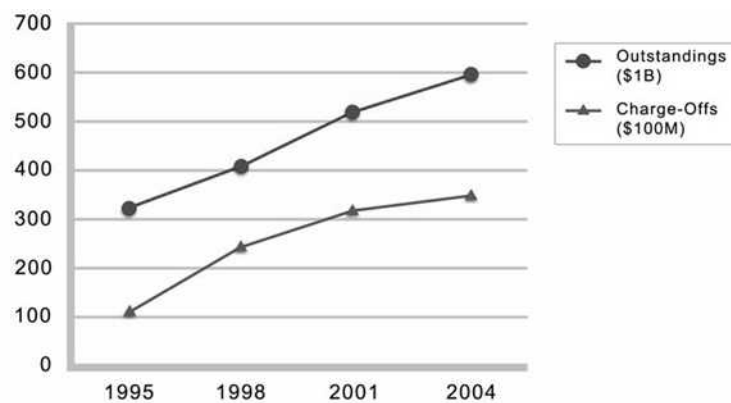
<sup>82</sup> As Tom Jackson noted twenty years ago, in comparing the relative ability of borrowers and lenders to bear risks, consumer borrowers (unlike, perhaps, publicly traded corporations) are much less able to diversify the risk of financial distress than lenders. Jackson, *supra* note 8, at 1400.

<sup>83</sup> See Elizabeth Warren, *The Phantom \$400*, 13 J. Bankr. L. & Prac. (2004) (describing that conventional syllogism and the implausibility of the notion that the increased charges amount to \$400 per year per US family).

modern credit card lender, increased delinquency rates suggest a greater number of borrowers likely to have an appetite for carrying balances at a level that is profitable for the lenders. Moreover, as those borrowers spiral deeper into financial distress, their switching costs increase, which makes it easier for the card issuer to charge them higher rates and fees. This may be because it will be difficult for the cardholder to find a new lender that will make an attractive offer to take over the entire account. Alternatively, it may be because new lenders will be unable to obtain sufficient information to price the account as well as the existing lender. It is not an accident that large card lenders recently have resisted sending complete information about their delinquent cardholders to the major credit bureaus.

To get a sense of the reality of the relationships, consider Figure 2, which sets out charge-offs and outstandings for the ten largest credit card banks over the last decade. As that figure shows, charge-offs have been rising steadily throughout the last decade, but there is no discernible evidence that the leading lenders have cut back their lending. Rather, their portfolios seem to have grown even more rapidly than the growth in charge-offs.

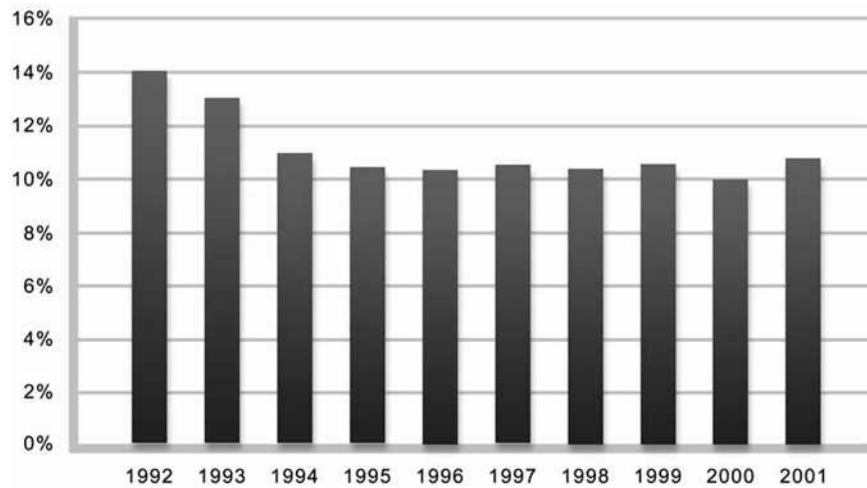
**Figure 2**  
Losses and Lending



*Source: Nilson Report 829*

Nor should we think that lenders have reacted to the increasing charge-offs by substantially increasing their interest rates. On the contrary, as shown in Figure 3, interest rates over the same period of time have fallen steadily (slightly, but steadily).

**Figure 3**  
Average Credit Card Markup



*Source: Federal Reserve Statistical Release G-19*

This is not to suggest that borrowers have no control over default. Of course they do. The appropriate policy question, however, is not whether borrowers have any control over default. The appropriate question is whether they are the only party that is in a position to limit the social losses of financial distress. If both borrowers and lenders are in a position to take steps to limit losses, then we should be asking how to allocate incentives between both parties to minimize the net externalized costs of financial distress. We might be able to trust the parties to minimize the costs they bear between themselves, but we cannot trust them to consider the losses others suffer.

Thus, to consider an analogy to payments policy, this is much like allocating losses from fraudulent use of credit cards. If all of the losses are placed on banks, they will have an incentive to use information technology to prevent those losses, but we might fear that cardholders would have inadequate incentives to take commonsense precautions to avoid theft of their cards or card numbers. Currently, our legal system operates on the implicit assumption that the hassle and inconvenience of card loss gives adequate incentive to cardholders, so the out-of-pocket losses from fraud are placed almost entirely on the card issuers.<sup>84</sup>

<sup>84</sup> See Ronald J. Mann, *A Payments Policy for the Information Age*, 93 *Geo. L.J.* 633 (2005).



In this context, a perspective that views the experience of consumer bankruptcy as a time for celebration and reveling by the released borrowers would worry that only a truly unforgiving bankruptcy system — or perhaps penal confinement — would be adequate to prevent widespread fraud.<sup>85</sup> In contrast, a perspective that views consumer bankruptcy — even in the United States in the 21st century — as a deeply humiliating and scarring personal experience would provide that bankruptcy alone gives substantial protection against moral hazard, and that judges could be relied on to identify cases of overt misconduct. This perspective would shift as much of the monetary losses as possible to lenders and in particular to adjusting lenders that are able to control financial distress through the ability to terminate the borrower's ability to obtain future funds.

It is not my purpose here to make detailed policy prescriptions. Generally, the analysis suggests that subordination of the debt of controlling, adjusting creditors would be an appropriate response. As a practical matter, in the United States, that suggests special rules that would subordinate the recoveries of credit card lenders to the recoveries of other general unsecured creditors. My general impression, however, is that such a rule would have a relatively minor impact, because of the large number of no-asset cases in which even general unsecured creditors would receive nothing. Thus, I am inclined to think that such a rule would make sense only as an adjunct to a tax on distressed debt of the kind discussed in Part II.

Against that backdrop, it seems worthwhile to consider the likely effects of the recently adopted Bankruptcy Abuse and Consumer Protection Act of 2005.<sup>86</sup> Recognizing that it is too early to know how the reforms will play out

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85 I discern such a perspective in Jones & Zywicki, *supra* note 2, and in LoPucki, *supra* note 30. The instinct that harsh punishment is necessary calls to mind the *cadena temporal* condemned as cruel by the Supreme Court in *Weems v. United States*, 217 U.S. 349 (1910).

86 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005). After struggling with bankruptcy reform for eight years, Congress passed the Act in April 2005, and President Bush signed it a few days later. The Act substantially amends the bankruptcy laws of the United States and will have its greatest impact in consumer bankruptcy cases. The legislation relating to consumer bankruptcy will make it more difficult for individuals to seek relief under Chapter 7 of the Bankruptcy Code. Among other changes, the Act imposes on consumer debtors who are above the median income a complex mathematical "means testing" formula to determine whether the case should be dismissed for an abuse of Chapter 7. The Act also will require the payment of greater amounts under a Chapter 13 plan for many consumer debtors and will alter provisions on exempt assets, reaffirmation of debts, and discharge of indebtedness for individuals.

in practice, it is still fair to examine the policy motivations that are apparent on the face of the statute to see how they compare to the policy recommendations and theoretical frameworks that I summarize above.<sup>87</sup> As a general matter, the revisions reflect acceptance of the premise that the primary empirical link of policy significance is that generous bankruptcy relief tends to increase the demand for credit but lower the incentive to repay, so that more rigorous bankruptcy relief would lead to higher repayment rates and thus lower interest rates.

Even that rationale can do little to justify the statute as written. Taken seriously, that premise would suggest that the reforms should apply only to newly incurred obligations, for which interest rates presumably would be lower. From an incentive perspective, permitting lenders to use the relatively rigorous collection incentives of the new Act to collect on debts already incurred under pre-existing contracts would only be a windfall.

Turning to the substance of the reforms, my view is that the reforms related to consumer bankruptcy seem likely to have effects directly opposed to the effects suggested by the analysis above. I focus on three separate points: the practical limitations on the use of Chapter 7, the likelihood that the reforms as a whole will lead to later filings by distressed consumers, and the practical elevation of the priority of Credit card lenders.<sup>88</sup>

The first problem is the portion of the reforms that is specifically designed to force consumers out of Chapter 7 and into Chapter 13, with a view to limiting the ability of bankrupts to discharge debts while earning a substantial post-discharge income. Quite apart from any concerns about the administrative practicality or utility of the provisions, as a matter of basic theory, they seem incongruous in light of the discussion above. My analysis suggests that the system should increase the incentive of lenders to take steps to minimize the costs of financial distress that card transactions externalize. Yet the revisions are designed explicitly to shift the costs of financial distress to the borrower.<sup>89</sup>

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87 For an examination of the relation between the Act and conservative economic theories, see Mary Jo Wiggins, *Conservative Economics and Optimal Consumer Bankruptcy Policy*, 7 *Theoretical Inquiries L.* 347 (2006).

88 I discuss these problems in more detail in Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 *Ill. L. Rev.* (forthcoming).

89 Another aspect of the reforms relates to the distinction between business-related consumer borrowing and spending-related borrowing. One thing that the revisions did not do is alter the provisions in the Bankruptcy Code, 11 U.S.C. § 707, that limit the chapter-shifting rules to debtors with "primarily consumer debts." Thus, chapter-shifting rules by their terms will not affect individuals who have incurred debts for business purposes. The empirical evidence discussed above does suggest

Second, if the general effect of the reforms is to lessen the benefits of bankruptcy, they may well cause some distressed borrowers to defer their bankruptcy filings.<sup>90</sup> As discussed above, what we know about consumer bankruptcy as it currently exists is that consumer borrowers probably file too late, not too early. The reforms are likely only to exacerbate that problem. The proposals that I discuss above, by contrast, are likely to cause people to file sooner by limiting the economic incentive of credit card issuers to continue lending.

Finally, to some degree, the revisions are likely to elevate the likelihood that credit card lenders will be repaid in bankruptcy above the likelihood that other unsecured creditors will be repaid.<sup>91</sup> Any such policy has a number of obvious adverse consequences. First, most obviously, credit card lenders<sup>92</sup> are more able to adjust to evidence of distress than other unsecured

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good reasons for the treatment of business-related lending. Still, however, there is considerable insincerity in the juxtaposition of the public policy to encourage that borrowing (and the related spending) with the subsequent harsh treatment of that borrowing in bankruptcy.

90 It is not clear to me that the reforms will result in a substantial reduction of total filings. If filings are almost entirely attributable to serious distress, as seems likely, then the likely effect will only be a deferral, which would be evidenced by a short-term downturn in filings.

91 The principal example here is § 310, which revises Bankruptcy Code § 523 to broaden the types of credit card debt that are presumptively not dischargeable. Among other things, any cash advance of more than \$750 will raise that presumption. So, for example, if a borrower less than 90 days before bankruptcy obtains a cash advance to pay rent or a medical bill or to shift balances from one credit card to another, the previously dischargeable debt now will become presumptively nondischargeable. It is difficult to know how serious that problem is. One UK agency estimates that borrowing money from one creditor to pay off another is a common practice in half of households suffering from financial distress. See Griffiths Commission, 2005 Report, *supra* note 44.

92 It is perhaps most notable that a variety of statutes that might have limited the prerogatives of credit card lenders or remedied more serious abuses in the process received little serious attention from Congress. Consider, for example, Credit Card Act of 2005, S. 499, 109th Cong. (2005) (prohibiting various credit card practices, enhancing disclosures, and the like); Bankruptcy Fairness Act, S. 329, 109th Cong. (2005) (increasing priority claims for nonadjusting creditors); Billionaire's Loophole Elimination Act, H.R. 1278, 109th Cong. (2005) (limiting protection for asset protection trusts); Medical Bills Interest Rate Relief Act, H.R. 1238, 109th Cong. (2005) (amending TILA with respect to credit card transactions related to medical bills). Also, recall the failure to consider an amendment that would have exempted victims of natural disasters, an oversight that has caused some to push for renewed consideration of an exemption following Hurricane Katrina. Peter G. Gosselin, *New Bankruptcy Law Could*

creditors.<sup>93</sup> Therefore, for example, provisions that make more credit card debts nondischargeable, place lenders on an even playing field with child support and alimony claimants. Because the bill does nothing to increase the assets in bankruptcy estates, claimants will be harmed even with enhanced priority positions in bankruptcy. The discussion above suggests that an optimal bankruptcy/finance policy would be searching for ways to increase the incentives of adjusting creditors with the ability to control their borrowers. If credit card lenders are the plainest examples of such lenders, and if credit card lenders also are the group whose lending most directly promises to create externalities of financial distress, then reforms should go in the opposite direction. Any reform that transfers value from nonadjusting creditors to adjusting creditors only exacerbates the externalities of the bankruptcy process by imposing losses on creditors that have not had an opportunity to spread them over a mass of voluntarily priced transactions. Thus, it would make much more sense to expand the category of priority unsecured claims to more comprehensively include the categories of nonadjusting creditors that currently share priority with adjusting credit card lenders. Thus, the revisions that directly benefit credit card lenders reflect a move in the wrong direction.<sup>94</sup>

### CONCLUSION

My purpose here has been to show how modern technology gives the issuer a ready capacity to limit financial distress through actions designed to limit

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*Exact a Toll on Storm Victims*, L.A. Times, Sept. 7, 2005, available at <http://democrats.assembly.ca.gov/members/a48/hurricane/press/h482005006.htm>.

93 As discussed above, the economics of the current situation give lenders an incentive to manage their lending in a way that optimizes the results of their entire portfolio, which might lead in many cases to greater amounts of lending at higher rates with less individualized assessment of particular loans. I am generally skeptical of reforms (like the EU's responsible lending initiative) that attempt to specify rules for lending; discussion of that topic in the annual reports of credit card issuers makes me doubt the ability of regulators to perform that task effectively. A more appropriate response, I think, is to alter the system so that the issuers designing their underwriting policies will internalize more of the costs of the distress that arises from their loans, and thus figure out the most sophisticated methods for lending less riskily.

94 Indeed, the only significant "reform" with regard to lending industry disclosure is the requirement that credit card companies provide the consumer with an "800" number to call, and unrealistic examples of credit card debt paydowns (which may not reflect the actual situation of the debtor and thus prove misleading), as well as a series of boilerplate warnings regarding real estate loans and teaser rates.

borrowing by distressed cardholders. The implication is that a sophisticated regulatory policy would harness that capacity by giving credit card issuers a monetary incentive to limit borrowing by the financially distressed. If that lending is privately profitable only because of the lender's ability to externalize the consequent costs of distress, the natural response would be to inhibit lending by internalizing the costs that lenders presently externalize. Among other things, that rationale supports mandatory minimum payment requirements, a tax on distressed credit card debt, and the subordination of payments to credit card lenders in bankruptcy.