Optimizing Consumer Credit Markets and Bankruptcy Policy

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Abstract

The link between consumer credit markets and bankruptcy policy is a complex one, acknowledged but not adequately examined in the existing scholarship. This essay argues that the causative relationships running between borrowing and bankruptcy compel a different strategy for policing the conduct of lenders and borrowers in consumer credit markets.

I begin by sorting out some of the realities of consumer lending that policy debates about bankruptcy "reform" have obscured. First, I discuss the empirical link between credit card use, on the one hand, and increased consumer spending and financial distress. That link suggests that the ability of transacting parties to externalize the costs of financial distress contributes to the steadily increasing use of credit cards. Second, I argue that there is no evidence that the relatively liberal discharge available in the United States has led to abusive borrowing and spending. Third, I discuss the evidence that suggests that a more accessible bankruptcy discharge relates to an increase in entrepreneurial activity, with the associated positive spillover effects.

The essay then turns to consumer credit regulation. Generally, it argues 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 argue instead for two alternate approaches. The first would be to impose mandatory minimum payments on credit card contracts. Experience in the market suggests, albeit tentatively, that this will cause some marginal reduction in the amount of borrowing and lead to faster termination of open-ended borrowing contracts by those most likely to default. The best approach, I argue, would be a tax on distressed debt, particularly defaulted credit-card debt, which would have the salutary effect of internalizing some of the costs of those transactions on a party well placed to limit their occurrence.

Finally, the essay turns to bankruptcy theory. Here, the essay challenges 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 the net externalized 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 the information technology at their disposal to limit the costs of distress. The specific legal rule I

recommend to further that end would be to subordinate the bankruptcy recoveries of adjusting, controlling creditors (credit-card lenders in the modern American example). I close by comparing the implications of my analysis with a few of the most salient provisions of the Bankruptcy Abuse and Consumer Protection Act of 2005, which are largely inconsistent with the concerns I raise.