



Consumer bankruptcy and default: The role of individual social capital

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ABSTRACT

In this paper, we empirically assess the role of individual social capital on personal bankruptcy and default outcomes in the consumer credit market. After controlling for a borrower's risk score, debt, income, wealth, and legal and economic environments, we find that default/bankruptcy risk rises and then falls over the lifecycle, while a borrower who owns a home or is married has a lower risk of default/bankruptcy. Moreover, a borrower who migrates 190 miles from his "state of birth" is 17% more likely to default and 15% more likely to file for bankruptcy, while a borrower who continues to live in his state of birth is 14% and 10% less likely to default and file for bankruptcy, respectively. A borrower who moves to a rural area is 9% and 7% less likely to default and declare bankruptcy, respectively. We also find that measures of social networks, norms, and cooperation and trust (i.e., aggregate social capital) are inversely related to consumer bankruptcy.

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1. Introduction

Sociologists define social capital as the social networks, norms, and cooperation and trust created by human interactions in a community (see e.g., Putnam, 1995, 2000). Accordingly, community engagement, e.g., voter turnout at referenda or membership in a non-profit organization, generates positive externalities. Conventional economic theory suggests that social interactions play a role in repeated games (Abreu, 1988), contract theory (Arrow, 1972), and solving free rider problems (Greif, 1993). Studies have found that social capital can enhance many desirable socioeconomic outcomes. For example, communities with higher social capital enjoy higher economic growth (Knack & Keefer, 1997) and greater judicial efficiency and lower corruption (LaPorta, Lopez-de-Silanes, Shleifer, & Vishny, 1997).

In this paper, we attempt to empirically assess the role of individual social capital on personal bankruptcy and default outcomes. Specifically, we use a loan-level panel data set of more than 170,000 credit cardholders to investigate the relationship between cardholder's bankruptcy and default behavior and his/her socioeconomic characteristics, which serve

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as proxies for the individual's social capital formation. In our data, we observe a borrower's default and bankruptcy filing status in each month over the sample period. We also have information that enables us to control for important financial distress factors that are predicted to drive a borrower into default or bankruptcy such as a borrower's "riskiness", spending, debt, income, and wealth, as well as economic conditions and legal environment. In addition, we have information on a borrower's socioeconomic characteristics (e.g., age, marital status, and homeownership status). Moreover, our data set is unique in that there's information about the zip code of an individual's current residence and the state of birth (or state of immigration entry for foreign born individuals), allowing us to identify mobility for each borrower. Thus, in addition to age, marital status, and homeownership status, our individual social capital variables also include: whether a borrower still lives in the "state of birth"; the distance in miles between the state of residence and state of birth; and whether a borrower has migrated to a rural area. With the information of individual social capital variables, we are able to investigate whether the risk of default or bankruptcy to be lower for a borrower who has higher individual social capital.

After controlling for an individual's credit risk score, spending, debt, income and wealth, as well as macroeconomic conditions and legal variations across states, we find that individual social capital variables can significantly explain cardholder bankruptcy and default outcomes. First, we find that defaults and bankruptcies rise and then fall over the lifecycle. Equally important, a borrower who is married is 24% less likely to default on his credit card debt and 32% less likely to file for bankruptcy. Finally, an individual who owns a home is 17% less likely to default and 25% less likely to file for bankruptcy.

Furthermore, we find that the risk of personal bankruptcy and default is higher for an individual who migrates out of his state of birth. For example, an individual who continues to live in his state of birth is 9% less likely to default on his credit card debt and 13% less likely to file for bankruptcy, while an individual who moves 190 miles from his state of birth is 17% more likely to default and 15% more likely to declare bankruptcy. Moreover, compared to individuals who move to an urban area, those who move to a rural area are 9% and 7% less likely to default and declare bankruptcy, respectively.

We also assess the correlation between Putnam's state social capital index (Putnam, 2000) and state bankruptcy filing rates in 2000. We find that states that are ranked higher on Putnam's social capital index (e.g., Vermont and Minnesota) have lower bankruptcy filing rates, while states that are ranked lower on the social capital index (e.g., Georgia and Tennessee) have higher bankruptcy rates. Controlling for variations in unemployment conditions, percentage of state population without health insurance coverage, and state bankruptcy laws, we find that states with a 1 point lower social capital index face a 0.3% points higher state bankruptcy rate per capita.

Our findings have some implications for the ongoing debate surrounding the rise in consumer bankruptcy over the past almost two decades. We show that individual social capital variables, such as mobility, rural residency, homeownership, marital status, and borrower age play a statistically and economically significant role in consumer bankruptcy and default outcomes. These individual social capital variables collectively can affect the strength of a community's social networks and norms and, in turn, shape the community's attitudes toward certain socioeconomic behaviors or outcomes. Therefore, the explanatory significance of an individual's social capital variables on the need to default on debt or to file for bankruptcy provide additional insights into the role of social capital on consumer bankruptcy.

Our paper also contributes to the literature studying the impact of social capital on household financial decision-making. Madrian and Shea (2001) find that an individual's decision to participate in a particular employer-sponsored retirement plan is influenced by the choices of their co-workers. Guiso, Sapienza, and Zingales (2004) find that Italian households in regions with higher social capital are more likely to use formal credit channels, such as writing more checks and investing in stocks. Hong, Kubik, and Stein (2004) show that people who attend church and interact with their neighbors are more likely to invest in the stock market.

A study which is closely related to ours is Buckley and Brinig (1998), which analyzes the impact of state-level social capital characteristics on aggregate consumer bankruptcy. The authors find that the rise in bankruptcy filings in 86 federal judicial districts over the 1980–1991 period can be attributed to higher per capital interstate migration into a state, plus inter-county migration within a state, and a smaller percentage of population living in metropolitan statistical areas. Thus, the explanatory significance of individual social capital variables on household default and bankruptcy outcomes in our study nicely complements that of Buckley and Brinig.

The paper proceeds as follows: Section 2 provides a brief theoretical motivation that articulates the relationship between consumer default behavior and individual social capital. Section 3 describes our data and empirical methodology. Section 4 discusses the empirical results, and section 5 concludes.

2. Individual social capital and consumer bankruptcy and default

Sullivan, Warren, and Westbrook (2000) show evidence of the two major causes of the recent increase in bankruptcy filings in the US: increases in credit card and mortgage debt; and unexpected adverse events (such as unemployment, divorce, health problems, or medical debts) have reduced the ability of households to repay their debt and eventually compel them to file for bankruptcy.¹ Despite such compelling evidence, many contend that increases in debt and adverse income or spending shocks cannot entirely explain the rise in consumer bankruptcy over the past almost two decades.

¹ See also Domovitz and Sartain (1999) and Barron, Elliehausen, and Staten (2000). Hence, Chatterjee, Corbae, Nakajima, and Rios-Rull (2007) incorporate simultaneously the role of household earnings and unsecured debt, as well as shocks to earnings, debt, and preferences (e.g., divorce) in their theoretical household default/bankruptcy dynamic equilibrium model.

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