Who gets credit after bankruptcy and why? An information channel

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Abstract

Conventional wisdom holds that individuals find it difficult to obtain new credit post-bankruptcy. Using credit bureau data, we test this hypothesis and show that more than 90% of bankrupt individuals receive credit shortly after filing. Individuals with good credit history prior to filing have reduced credit availability after bankruptcy while those with ex-ante low credit quality receive more credit. We show that credit supplied to low quality individuals is severely curtailed during the financial crisis. We also find that the default probability on new debt increases after bankruptcy, especially among individuals with high ex ante credit score. These findings are consistent with an information channel, in which bankruptcy reveals new information about a borrower's credit quality.

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1. Introduction

As consumer credit and personal bankruptcy have grown in the past two decades (see White, 2007), an extensive literature studying the dynamics of these two has grown as well. However, there has been little work on what happens to consumers’ access to credit after they file for bankruptcy, primarily due to the relative lack of suitable data.\textsuperscript{3}

Post-bankruptcy credit access has a number of implications. For example, access to credit markets after bankruptcy can be an important factor in an individual’s original decision to file for bankruptcy. Similarly, understanding post-bankruptcy dynamics is important for the debate on “fresh start”—the option to discharge one’s debt as a mechanism to smooth household consumption against idiosyncratic risks. Finally, the patterns of post-bankruptcy lending can provide key insights into whether bankruptcy signals an increased propensity to default on new debt; or instead, it leads to improved credit quality as borrowers debts are discharged.

In this paper, we use credit bureau data to provide empirical evidence on access to credit after bankruptcy. Analyzing post-bankruptcy credit is important because it helps us understand how lenders use the information available in credit reports to make their lending decisions. In accordance with the Fair Credit Reporting Act (FCRA), a bankruptcy flag may appear on an individual’s credit report for up to ten years after filing, and therefore, the bankruptcy event may affect credit supplied to these individuals in the future. Additionally, bankruptcy law precludes individuals from filing again within 8 years of the filing date, which may also affect lenders’ decision to provide credit to bankrupt individuals.

In this paper, we argue that the patterns observed in the data are consistent with an information channel under which the bankruptcy filing itself confers new information about a borrower’s future credit quality. This channel is very similar to the reputation literature that goes back to the seminal paper by Diamond (1989) on acquisition of reputation in debt markets and the international literature on sovereign debt default and its impact on access to credit markets as in Cole et al. (1995). Chatterjee et al. (2011) provides a nice application of these papers to unsecured credit markets where lender learns from an individual’s borrowing and repayment behavior about his type and encapsulates his reputation for not defaulting in his credit score.

Our empirical methodology comprises two steps. The first step is a counterfactual analysis in which we compare the actual amount of credit received by individuals after they file for bankruptcy to the amount of credit that individuals with similar...
bankruptcy, we can infer that bankruptcy revealed some negative information content of the bankruptcy filing itself about a borrower. The two closest related papers to ours, Han and Li (2011) and Musto (2004), use data exclusively after bankruptcy filings, and therefore they do not control for observable characteristics before filing. More specifically, their analysis compares filers and non-filers while our analysis compares the same individual before and after bankruptcy. Our data is comprised of two panels taken at different points in time and each panel has two observations for up to 10 years after a filing, this disadvantage may persist as the economy moved into crisis by 2007, access to credit is severely curtailed for low quality borrowers, and as a result, they no longer show ‘gains’ from bankruptcy. This finding is also consistent with the general idea of a ‘flight-to-quality’, where lenders redistribute available resources away from low quality borrowers. For an example, see Gropp et al. (1997) who find that in high exemptions states, there is a redistribution of credit to households with more financial assets while poor households receive less credit.

The observed patterns in the data are consistent with the idea that a bankruptcy filing may contain valuable information on borrowers’ credit quality going forward. This kind of asymmetric information in lending is what led to the creation of consumer credit bureaus, including the one that provided information for this study. However, even with credit bureau information, information asymmetries between lenders and borrowers persist. In a framework where lenders have limited information about a borrower’s type and earnings realizations, they can use repayment behavior and bankruptcy as a signal. In fact, bankruptcy does negatively affect credit scores, and because the bankruptcy flag remains on credit reports for up to 10 years after a filing, this disadvantage may persist for some time. Accordingly, it is not surprising that bankruptcy is associated with at least some penalty on average.

To the extent that bankruptcy signals higher future default probabilities, the filing of an ex-ante low credit-quality borrower who already had a bad repayment record carries less information than the filing of a high-quality borrower who had a demonstrated good credit history. Thus as our analysis reveals, credit access of the latter would change more dramatically than the former. To support this interpretation, we test the hypothesis that the change in credit score fully captures the credit risk changes of a bankruptcy filing. We reject this hypothesis and conclude that the bankruptcy filing contains information about borrowers’ creditworthiness beyond what is implied by the change in credit score. This result is significant because it implies that credit scoring models may be insufficient to characterize the credit risk of bankrupt individuals, which could lead to misallocation or mispricing of credit.

More specifically, we show that the probability of default on new loans after bankruptcy increases significantly for the ex-ante high-quality borrowers, but not for the lowest quality ones who already had high default probabilities before bankruptcy. For example, the 90-day delinquency increases by a factor of 10 for the highest credit score group while it remains about the same for the lowest credit score group. This finding reinforces the idea that bankruptcy conveys more information on ex-ante high-quality borrowers than it does on low quality ones. The empirical patterns observed in the data from the credit boom period (2003–2004) to the onset of the financial crisis (2006–2007) are similarly consistent with this information channel. With the overall rise in bankruptcies and defaults during the financial crisis, the interpretation of each individual bankruptcy signal became somewhat confounded. It is more difficult for lenders to infer information from the bankruptcy signal and to learn about an individual borrower’s type when aggregate factors affect all borrowers simultaneously.

The primary confounding factor in our empirical analysis is the potential interaction between the borrowers’ demand for credit and the lenders’ credit supply. For example, individuals with good
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