The Effect of the 2005 Bankruptcy Reforms on Credit Card Company Profits and Prices (2)

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The views expressed are those of Michael Simkovic and do not reflect the views of Harvard Law School, the Olin Center or McKinsey & Company.

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Abstract
The U.S. Bankruptcy code changed dramatically with the passage of The Bankruptcy Abuse Prevention and Consumer Protection Act Of 2005. This act increased the costs and decreased the benefits of bankruptcy to consumers. Supporters of the law claimed that it would benefit consumers as well as creditors, because reducing the losses faced by creditors would lower the cost of credit to consumers. Critics of the law depicted it as special interest legislation designed to profit credit card companies at the expense of consumers. This study tests whether the 2005 Bankruptcy Reform: (1) reduced the number of bankruptcies; (2) reduced credit card company losses; (3) lowered the cost to consumers of credit card debt; and (4) increased credit card company profits. The data suggests that although bankruptcies and credit card company losses decreased, and credit card companies achieved record profits, the cost to consumers of credit card debt actually increased. In other words the 2005 bankruptcy reforms profited credit card companies at consumers’ expense.
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Did 2005 Bankruptcy Reform Reduce the Cost of Credit Card Debt?

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1. **Introduction: An empirical approach**

This study values data over assumptions. This study does not assume on faith—as many free market and pro-business scholars tend to—that markets are competitive and transparent; that consumers are rational and well informed; that transactions costs are minimal; or that regulations are always inefficient. Nor does this study assume on faith—as many liberals and consumer activist scholars tend to—that markets are oligopolistic or monopolistic; that there are significant information asymmetries; that consumers have limited information and rationality; that large corporations manipulate consumers; or that the interests of large corporations and consumers are necessarily at odds.

Instead, this study analyzes data to determine the effect of a legal change on the credit card market. The data will reveal whether the legal change benefited consumers, which will reveal whether the credit card market is price-competitive. This data-driven, ideologically neutral approach will, it is hoped, inform future debate about regulation of consumer credit and optimal bankruptcy policy.

2. **Background on bankruptcy reform**

2.1. *The new consumer bankruptcy law*

On April 20, 2005, President Bush signed into law *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* [both the law and the bill are hereafter abbreviated as “2005 Bankruptcy Reform”] which changed the bankruptcy code to make it more difficult for consumers to discharge debt through bankruptcy (Mann 2007, 377). Most of the key provisions of 2005 Bankruptcy Reform went into effect 180 days later on October 17, 2005.
2005 Bankruptcy Reform limited the discharge of debt by: (1) broadening the categories of debt that are non-dischargeable and (2) by using “means testing” to dismiss many Chapter 7 bankruptcy cases and force debtors to file for Chapter 13 instead. \(^2\) 2005 Bankruptcy Reform also created barriers to filing by raising filing fees, lengthening the period between permitted filings, and increasing the costs and risks faced by professionals who assist consumers filing for bankruptcy (Mann 2007, 377).

The most likely beneficiaries of the new law are unsecured lenders, such as credit card companies. Whereas secured creditors, such as mortgage or auto lenders, are protected under Chapter 7 by their security interests in the debtor’s house or car, unsecured creditors often receive little or nothing in a Chapter 7 bankruptcy. Pushing filers into Chapter 13 would increase recovery for these unsecured creditors (Mann 2007, 379-80). Furthermore, delaying bankruptcy allows unsecured credit card lenders to increase their claims through accrual of interest at high pre-petition contractual rates, and to collect more from debtors who are not yet shielded by the automatic stay (Mann 2007, 392-93).

2.2. Supporter of bankruptcy reform promised cheaper consumer credit

A key justification for 2005 Bankruptcy Reform was that it would make credit more affordable to consumers. President Bush explained that he signed the law to “help make credit more affordable, because when bankruptcy is less common, credit can be extended to more people at better rates” (Bush 2005). Similarly, the House of Representatives Report approvingly cited the Senate Judiciary Committee testimony of Professor Todd Zywicki excerpted below:

\(^2\) Chapter 7 is preferable to Chapter 13 for many financially distressed consumers because Chapter 7 results in a discharge of many debts, leaving future income relatively unencumbered, while Chapter 13 requires debtors to repay their debts from future income. (Mann 2007, 377).
[W]hen creditors are unable to collect debts because of bankruptcy, some of those losses are inevitably passed on to responsible Americans who live up to their financial obligations ...We all pay for bankruptcy abuse in higher down payments, higher interest rates, and higher costs for goods and services (House Report, 2005).

In his full testimony, Professor Zywicki specifically argued that bankruptcy increases the price that consumers pay for credit card debt across multiple price points and that 2005 Bankruptcy Reform would reduce these costs to consumers (Zywicki 2005).

This bankruptcy “tax” takes many forms. It is obviously reflected in higher interest rates...It is [also] reflected in shorter grace periods for paying bills and higher penalty fees and late-charges for those who miss payments...[R]educing the number of strategic bankruptcies will reduce the bankruptcy tax paid by every American family...These reforms will make the bankruptcy system more fair, equitable, and efficient, not only for bankruptcy debtors and creditors, but for all Americans (Zywicki 2005).

This promise of cost savings to the average American family was critical to the passage of 2005 Bankruptcy Reform. As Professor Elizabeth Warren, a leading critic of bankruptcy reform explained in 2004:

[I]t is hard to persuade Congress to vote for something that could easily be characterized as a bill to squeeze hard-working families down on their luck in order to improve profits for a few big corporate lenders. [Claims of cost savings to the average family are] a way to appear to align the interests of ordinary families with billion-dollar multi-national lenders...[A] promise of $4003 to each hard-working family in America will give politicians plenty of political cover for their votes [in favor of 2005 Bankruptcy Reform] (Warren 2004, 86).

With the promise that any gains from 2005 Bankruptcy Reform would not be captured by lenders, but would be shared widely with the voting public, advocates of 2005 Bankruptcy Reform garnered more widespread support for the law.

2.3. Critics doubted that bankruptcy reform would lead to cheaper credit card debt

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3 The $400 is an estimate of the cost of bankruptcy to each American family. According to Professor Warren, the $400 estimate was devised by lobbyists working for the credit industry using dubious analytical methods, then spread as a ‘fact’ through an aggressive, well-funded lobbying and public relations campaign (Warren 2004, 77-81).
Supporters and critics of bankruptcy reform both agreed that the new law would benefit credit card companies. However, critics were skeptical that benefits would be passed on to consumers.

Critics were skeptical for two reasons: (1) because bankruptcy reform advocates’ financial ties to the credit card industry suggested that they might be more interested in increasing credit card company profits than in benefitting consumers; and (2) because the history of the credit card industry suggested a tenuous link between bankruptcy rates and credit card pricing.

Critics such as Professor Elizabeth Warren (2004, 87), Professor Ronald Mann (2007, 376), and Senator Edward Kennedy (Mann 2007, 376) have pointed out the extensive role played by the credit card industry in drafting the 2005 bankruptcy reform bill, advocating for its passage, and funding the campaigns of politicians who voted in favor of it. They argued that the role of credit card companies indicated that the bill was contrary to the interests of consumers.

This argument is rhetorically powerful, but is only persuasive if one believes that there is an inherent conflict of interest between credit card companies and their customers. Although the credit card industry clearly believed that it would profit from 2005 Bankruptcy Reform, this alone does not imply that consumers would not benefit as well.

Critics made a more sound argument when they pointed to historical data suggesting a tenuous link between bankruptcy rates and credit card prices. Historically, bankruptcy rates have not correlated with either interest rates on consumer credit cards, or with the spread between consumer credit card interest rates and the risk free rate (Law Professors’ Letter on S. 256, 2005). Critics did not claim to be certain that consumers would not benefit, but argued that there was at least good reason to be skeptical that consumer benefits would materialize.
3. Methods and data

Advocates of bankruptcy reform such as Zywicki suggested that customers would see savings in the costs of both credit card debt and other credit products. This paper focuses only on credit card debt for three reasons: (1) credit card companies are the most likely and uncontroverted beneficiaries of the new law;\(^4\) (2) it was unknown whether or not the benefits to creditors such as credit card companies would be passed on to consumers; and (3) it is relatively easy to measure whether credit card companies benefited from 2005 Bankruptcy Reform and whether those benefits were passed on to consumers.

If President Bush, Professor Zywicki, and other supporters of 2005 Bankruptcy Reform are right, then 2005 Bankruptcy Reform should have had the following effects: (1) reduced the number of personal bankruptcies; (2) reduced credit card company losses; and (3) reduced the cost of credit card debt to consumers. These costs savings could manifest across credit cards’ multiple price points, including (1) late fees, (2) over-limit fees, (3) annual fees, (4) interest rates and (5) grace periods.

This study tests whether or not 2005 Bankruptcy Reform led to these effects by comparing absolute levels and trends—in personal bankruptcies, credit card lenders’ charge-offs, late fees, over-limit fees, interest rates, and grace periods—before and after 2005 Bankruptcy Reform.

This study controls for factors other than 2005 Bankruptcy Reform that could have led to higher or lower costs of consumer credit by considering changes in the risk free interest rate, which reflects broad macroeconomic factors that affect economy-wide costs of credit. This study uses the

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\(^4\) This is because credit card lenders are unsecured creditors. See discussion above in section 2.1.
yield on the 5 year treasury as the risk free rate to match the duration of credit extended to the typical household carrying a credit card balance.5

This study also tests other possible outcomes of 2005 Bankruptcy Reform—such as an increase in credit card industry profits—and considers factors that might explain such an outcome, including the level of credit card industry concentration, price competition, and price transparency.

Data sources include CardWeb CardData (for credit card interest rates, fees, grace periods, and industry profits), the FDIC Quarterly Banking Profile (for credit card lenders’ charge-offs), Administrative Offices of the United States Courts (for personal bankruptcy filings), Bloomberg (for risk free interest rates), and the Nilson Report (for credit card industry concentration).

This study uses CardData for credit card interest rates because it is more comprehensive than the other leading data source, the Federal Reserve G.19. Whereas CardData is gathered by regular direct survey of 150 issuers, representing 97% of the market, G.19 data is based on a survey of the 50 largest card issuers and limited sampling of others.6

4. Results: The effects of bankruptcy reform on the credit card industry

4.1. Bankruptcies and credit card company losses fell sharply

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5 The average household carrying a credit card balance has been carrying it for over 3.5 years, and families with larger balances tend to carry their debt for longer than those with smaller balances (Demos 2005, 8). This suggests that the average length of time it takes a borrower who carries a balance to repay credit card debt—or default on it through bankruptcy—is somewhat longer than 3.5 years. Results do not differ significantly with other reasonable risk free rates (i.e., the 10 year treasury).

6 CardData has another advantage over Federal Reserve G.19 data: CardData more accurately reflects the long run trend in interest rates. CardData excludes “teaser rates” (defined as temporary rates lasting 1 year or less). Teaser rates can introduce substantial variability in nominal interest rates without significantly reducing borrowers’ actual cost of borrowing. The average household carrying a balance on its credit card has been carrying it for over 3.5 years, and families with larger balances tend to carry their debt for longer than those with smaller balances (Demos 2005, 8). Although families carry balances for significantly longer than the 3-12 month term of a teaser rate, they generally fail to switch to a lower interest card when the teaser rate expires (Shui and Ausubel 2004). This enables credit card companies to acquire customers who are likely to carry balances by offering a low introductory rate, and then profit by charging them a much higher rate for several years.
As figure 1 below demonstrates, after 2005 Bankruptcy Reform went into effect, both personal bankruptcy filings and credit card company losses sharply declined.\footnote{The bars represent quarterly personal bankruptcy filings, in thousands. The line represents credit card company charge-offs as a percent of average loans and leases. The chart appeared in the FDIC’s Quarterly Banking Profile, but has been modified for this paper to indicate the timing of bankruptcy reform. The timing of bankruptcy reform is represented by the large grey vertical rectangle, pointed out by the large down arrow. 2005 Bankruptcy Reform was enacted at the left most portion of the rectangle, and its key provisions went into effect at the right most portion of the rectangle. This convention for representing the timing of 2005 Bankruptcy Reform is used for all charts in this paper. The data for this chart appears in the appendix, in Table 1.} Figure 1 also demonstrates the historical correlation between personal bankruptcy filings and credit card company loss rates.

[Figure 1]

Figure 1 illustrates a spike in bankruptcy filings between the time 2005 Bankruptcy Reform was enacted and the time it went to effect as consumers scrambled to file under the old, more debtor-friendly rules. The sharp drop in bankruptcy filings in 2006 may be due in part to households on the verge of bankruptcy in 2005, who would have filed in 2006 if not for 2005 Bankruptcy Reform, deciding to file a year early.

Nonetheless, at least some of the reduction in bankruptcy filing rates and credit card company losses appears to be permanent. Although bankruptcy filings and loss rates increased in 2007 compared to 2006, 2007 rates remained significantly below recent pre-2005 Bankruptcy Reform rates (2002-2004). Figure 2 below shows annual credit card loss rates during, before, and after 2005 Bankruptcy Reform.

[Figure 2]

In 2006, losses as a percent of loans were 25% lower than in 2005.\footnote{Loan losses fell from 4.64% to 3.48%.
} In 2007, losses as a percent of loans were 15% lower than in 2005.\footnote{Loan losses fell from 4.64% to 3.95%.
}

The value of this decrease in credit card loss rates to credit card companies is difficult to estimate with precision, but may be as high as $8.6 billion in 2006 and $5.8 billion in 2007.\footnote{The bars represent quarterly personal bankruptcy filings, in thousands. The line represents credit card company charge-offs as a percent of average loans and leases. The chart appeared in the FDIC’s Quarterly Banking Profile, but has been modified for this paper to indicate the timing of bankruptcy reform. The timing of bankruptcy reform is represented by the large grey vertical rectangle, pointed out by the large down arrow. 2005 Bankruptcy Reform was enacted at the left most portion of the rectangle, and its key provisions went into effect at the right most portion of the rectangle. This convention for representing the timing of 2005 Bankruptcy Reform is used for all charts in this paper. The data for this chart appears in the appendix, in Table 1.}
true value is likely slightly lower because this estimate is based on revolving credit, which is primarily but not exclusively credit card debt,\textsuperscript{11} and because some of the decrease in charge-offs may be due to factors other than bankruptcy reform, such as improved information technology or collections techniques.

4.2. Credit card late fees and over-limit fees increased while grace periods decreased

Fees have been climbing and becoming less transparent over the years\textsuperscript{12} and there is no evidence that 2005 Bankruptcy Reform reversed this trend. Figure 3 below shows that over-limit fees and late fees have been climbing since well before bankruptcy reform, and that this trend continued after 2005 Bankruptcy Reform. At the same time, annual fees—which as an upfront flat

\textsuperscript{10} The value can be estimated as follows: First calculate the total decrease in charge-offs by multiplying the average revolving credit balance for the year (which roughly approximates credit card debt, but also includes other forms of debt) by the decrease in loss rates between pre- and post-bankruptcy reform years. Then calculate the gain from the decrease in charge-offs by subtracting the price at which credit card companies can sell recently charged-off debt to collection agencies—typically 8 cents on the dollar (Weston).

In 2006, revolving credit—mostly credit card debt—averaged roughly $850 billion (Federal Reserve Statistical Release G.19). Loss rates fell from roughly 4.6% in 2005 to roughly 3.5% in 2006 (FDIC Quarterly Banking Profile). 4.6% – 3.5% = 1.1%. $850 billion x 1.1% = $9.35 billion. $9.35 billion – (8% x $9.35 billion) = $8.6 billion.

In 2007, revolving credit averaged roughly $900 billion (Federal Reserve Statistical Release G.19). Loss rates fell from roughly 4.6% in 2005 to roughly 3.9% in 2007 (FDIC Quarterly Banking Profile). 4.6% – 3.9% = 0.7%. $900 billion x 0.7% = $6.3 billion. $6.3 billion – (8% x $6.3 billion) = $5.8 billion.

\textsuperscript{11} There is no government statistic measuring only credit card debt. (Levitin 2007, 3 fn. 2).

\textsuperscript{12} In 2000, Professor Żywicki wrote that rather than increase interest rates, credit card companies instead increased late fees and over-limit fees, “so called ‘hidden fees.’” ( Żywicki 2000, 33). According to the Government Accountability Office, many consumers do not fully appreciate these fees because of faulty disclosure by credit card companies. Furthermore, the portion of credit card company revenues attributable to penalty fees has been climbing (GAO Report 2006). At the same time, credit card companies reduced or eliminated more transparent annual fees because of “hostility of consumers…evidenced by the fact that when annual fees were first imposed, consumers canceled over 9 million bank cards in 1980, amounting to some 8% of the outstanding total” (Żywicki 2000, 54).

Average late fees among credit card companies with portfolios larger than $100 million climbed from under $13 in December 1994 to over $35 in December 2007 (CardWeb CardData). During the same period, over-limit fees climbed from less than $11 to more than $26 while annual fees on standard credit cards fell from $17 to $13 (CardWeb CardData).
fee, are the most transparent and easiest for consumers to understand and comparison shop—have been falling since well before 2005 Bankruptcy Reform, and continued to fall afterward.

[Figure 3]

Average late fees increased 5% from April 2005 to December 2007. During the same period, over-limit fees increased 17% (CardWeb CardData). A substantial proportion of credit card users pay late fees and over-limit fees. In 2005, issuers reporting to the GAO charged late fees to 35% of their active U.S. accounts and over-limit fees to 13% of their active U.S. accounts (GAO Report, 2006).

The likelihood of incurring a late fee has increased over time as credit card companies reduced grace periods. This trend continued after 2005 Bankruptcy Reform, as shown in Figure 4 below.

[Figure 4]

Grace periods fell 1.5% from 2005 to 2007 (CardWeb CardData).

4.3. Credit card interest rates and the spread above the risk free rate both increased

The interest rates charged by credit card companies have increased after 2005 Bankruptcy Reform. Figure 5 below shows that the annual percentage rate (APR) on standard, gold, and platinum cards have all increased.

[Figure 5]

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13 See footnote 12 above.
14 As early as 2000, Professor Zywicki reported “the virtual elimination of annual fees” and that remaining annual fees were generally tied to particular services, such as frequent flyer miles, not plain vanilla cards offering only payment and credit services (Zywicki 2000, 54).
15 Fees are for portfolios greater than $100 million. Fees for portfolios less than $100 million showed a similar pattern. The GAO estimates that 10% of credit card company revenues come from penalty fees (GAO Report 2006, 67).
APRs on standard credit cards increased 8% from April 2005 to December 2007. The GAO estimates that 70% of credit card company revenues come from interest charges (GAO Report 2006, 67).

To control for broad macro-economic factors unrelated to 2005 Bankruptcy Reform that might affect interest rates, this analysis considers not only the interest rate credit card companies charge their customers, but also the risk free rate. Figure 6 below shows that after 2005 Bankruptcy Reform, the risk free rate leveled off and then declined.

[Figure 6]

The risk free rate declined 12% from April 2005 to December 2007 as the yield on the 5 year T-note fell from 3.9% in April 2005 to 3.5% in December 2007 (Bloomberg). If the spread between the risk free rate and credit card interest rates had remained flat, credit card interest rates would have dropped from 17.7% in April 2005 to 17.3% in December 2007.

However, credit card interest rates actually increased to 19.1% in December 2007. As the risk free rate declined, credit card interest rates continued to rise, increasing the spread by 14%. Figure 7 below shows the dramatic increase in the spread after bankruptcy reform went into effect.

[Figure 7]

Even if the spread had remained the same, customers would be unambiguously harmed because credit would be no less expensive, and customers would lose the value of the protection afforded them under the old bankruptcy code. That the spread widened highlights the fact that credit card companies benefited at consumers’ expense.

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16 APRs increased from 17.7% to 19.1%. The 8% increase refers to the percent increase above the 17.7% APR in April 2005 (19.1%/17.7% - 1).
17 The spread increased from 13.8% to 15.7%.
4.5. Credit card companies achieved record profits

Even though credit card companies saved billions in reduced loan loss rates after 2005 Bankruptcy Reform,\(^{18}\) prices increased 5% to 17%.\(^{19}\) This combination of lower costs and higher prices drove record profits, as shown below in Figure 8.

[Figure 8]

5. Discussion: A market with minimal price competition

What could explain the lack of benefit to consumers, in spite of the clear benefit to credit card companies? Credit card companies can retain the benefit of fewer bankruptcies rather than pass it on to their customers if credit card companies can avoid competing with one another on price.

There are several factors that enable credit card companies to avoid price competition. One is industry consolidation. Figure 9 below shows the trend toward consolidation, which had been going on for some time, continuing after bankruptcy reform.

[Figure 9]

In 2005, the top 10 issuers controlled 87% of the market. 10 years earlier, the top 10 controlled only 56% (Nilson Report). With fewer companies controlling a larger share of the market, it has become easier to avoid “price wars” (the real-world equivalent of the competitive markets described by economics textbooks) that benefit consumers but harm all of the producers in an industry.\(^{20}\)

Credit card companies may also be able to avoid price competition because switching costs are high for the most profitable customers (Mann 2007, 388-89; Calem 2006). The most profitable

\(^{18}\) See section 4.1 above.
\(^{19}\) Except for annual fees, which were in decline long before bankruptcy reform. See section 4.1.
\(^{20}\) It also has become easier for credit card companies to organize and coordinate mutually beneficial activity, such as lobbying Congress to change the bankruptcy laws.
customers are those that are financially distressed, because they are the most likely to rack up interest charges and fees. However, these financially distressed customers can suddenly cease to be profitable when they become unable to repay their debts or when they discharge their debts through bankruptcy. Customers’ existing credit card companies have a great deal of proprietary information—what the customer buys, when the customer began falling behind on his or her debts, how far behind he or she is, the monthly payment he or she makes, etc.—that improves the credit card companies’ ability to predict when the customer will cease to be profitable. Would-be competitors lack this information. It is therefore very risky and costly for a competitor to try to poach financially distressed customers from their existing card company. This results in an environment in which price competition is limited, and in which cost savings are more likely to be retained by the credit card companies than passed on to customers.

The credit card industry might also be able to avoid price competition because of complex, multi-tiered pricing that can make it difficult for customers to comparison shop (Levitin 2007, 18). Pricing can include multiple variables—annual fees, late fees, over-limit fees, currency conversion fees, cash-advance fees, standard interest rates, cash-advance interest rates, introductory interest rates, penalty interest rates, etc. These fees and interest rates—complex in their own right—are presented in a form that is difficult to understand (GAO Report 2006). Customers faced with such complex pricing systematically miscalculate and underestimate the cost of credit card debt (Levitin 2007, 24-5).

22 Professor Warren recently testified before the Senate about several techniques used by credit card companies that make credit card agreements and prices difficult to understand. (Warren 2007) According to Professor Warren, these “tricks” reduce transparency and contribute to a market that is not price-competitive.
The empirical record on consumers’ ability to comparison shop points toward a market that is far from price-competitive. Studies have shown that most consumers will irrationally choose a card with a low introductory interest rate over a less expensive card with a higher introductory rate. After the introductory rate expires, these consumers generally fail to switch to a lower interest card (Shui and Ausubel 2004). According to the GAO, many consumers do not fully appreciate—and therefore cannot comparison shop—late fees and penalty interest rates because of faulty disclosures by credit card companies (GAO Report 2006)(See also Warren 2007). Studies suggest that although customers who were assessed late fees in the recent past can learn to avoid fees in the short-term future, the learning is at best temporary (Agarwal et. al. 2008). Finally, although over half of consumers can rationally choose between a lower interest rate card with an annual fee and a higher interest rate with no annual fee, a substantial minority (40%) will initially make the wrong choice (Agarwal et. al, 2006). Whatever the underlying reason, rising prices in the face of falling risks and costs demonstrate that the credit card industry is not price-competitive.

This settles a debate that stretches at least as far back as 2000, when Professor Zywicki published an article defending credit card companies against charges that the industry was not competitive and that regulations could squeeze their profit margins without harming consumers. Professor Zywicki wrote: “If the credit card market is largely competitive, then bankruptcy losses will [be passed on] to consumers, rather than being primarily a wealth transfer from credit card issuers to consumers in the form of reductions in these profits” (2000, 44). This statement is logically equivalent to “If reduced bankruptcy losses merely increase credit card company profits rather than being passed on to consumers in the form of lower prices, then the credit card market is not largely competitive.”
Zywicki asserted that the industry was competitive, even though credit card interest rates did not respond to rising bankruptcy losses, because credit card companies passed those costs on to consumers in other ways: through “increased fees and penalties for late payments and [over-limit fees]...[T]he increase in these fees by card issuers is a direct response to the increased default rate in recent years” (Zywicki 2000, 33); and through “the steady erosion in the length of the non-interest grace period” (Zywicki 2000, 34).

The fact that after bankruptcy reform, interest rates and fees continued to rise and grace periods continued to fall, even though credit card companies reaped tremendous gains from declining bankruptcy losses demonstrates—under the very criteria set forth by Professor Zywicki, the leading advocate of bankruptcy reform and of credit card industry competitiveness—that the credit card market is not price-competitive. This lack of price competition explains why the benefits of bankruptcy reform accrued exclusively to credit card lenders and were not shared with the average American family, and why—by Professor Zywicki’s own criteria—bankruptcy reform was a failure.

6. **Conclusion: Legislative intent and competitive markets**

The data is unambiguous: 2005 Bankruptcy Reform benefited credit card companies and hurt their customers. While bankruptcy protection became increasingly unavailable, credit card companies increased prices by 5% to 17%. This contributed to a 25% increase in credit card industry annual profits from 2005 to 2007. 2006 profits were $7 billion higher than 2005, and 2007 profits were $10 billion higher—$17 billion in additional profit over two years (CardWeb CardData).23

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23 Bank credit card annual pre-tax profits, excluding debit cards and private label credit cards, were $30.6 billion in 2005, $37.5 billion in 2006, and $40.3 billion in 2007. ($40-30) + ($37-30) = $17.
According to the legislative history, hurting consumers in order to help credit card companies was not what members of Congress intended when they voted for 2005 Bankruptcy Reform.\(^\text{24}\) It is possible that members of Congress made an honest mistake and will correct it by changing the law. But it is also possible that members of Congress intended to increase credit card lenders’ profits regardless of the impact on consumers. How members of Congress react to the data will reveal at least as much about their intentions as the Congressional Record.

The debates over 2005 Bankruptcy reform were marked by the almost religious certainty with which advocates of bankruptcy reform claimed that bankrupt consumers were imposing costs on middle class American families, which 2005 Bankruptcy Reform could alleviate (Zywicki 2005)\(^\text{(italics added)\)}:

[T]hose who pay their Bills inevitably have to pay more to make up for those who do not. Like all other business expenses, when creditors are unable to collect debts because of bankruptcy, some of those losses are inevitably passed on to responsible Americans who live up to their financial obligations. Every phone bill, electric bill, mortgage, furniture purchase, medical bill, and car loan contains an implicit bankruptcy “tax” that the rest of us pay to subsidize those who do not pay their bills. Exactly how much of these bankruptcy losses is passed on from lenders to consumer borrowers is unclear, but economics tells us that at least some of it is.

There were many claims of “inevitability” for something that now seems to not be true. If there were a bankruptcy “tax,” then presumably there would have been a bankruptcy “tax rebate” upon the passage of 2005 Bankruptcy Reform.\(^\text{25}\) At least with respect to credit cards, there has not been one. In fact, prices have increased.

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\(^\text{24}\) The bill, S.256, was voted on along party lines. Every Republican in the Senate voted for the bill, as did all but three Republicans in the House of Representatives (the three other Republicans abstained). A majority of Democrats in both the House and Senate voted against the bill. Even so, a significant minority of Democrats (roughly one third of Democratic House members and 40% of Democratic Senators) voted in favor of the bill. A roll call for the Senate is available at http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=109&session=1&vote=00044#position

\(^\text{25}\) A roll call for the House is available at http://clerk.house.gov/evs/2005/roll108.xml

Indeed, the credit industry essentially claimed as much with its advertisements of the $400 bankruptcy tax.
In fairness to Professor Zywicki, predicting the future is always perilous, and his predictions would have been reasonable if the credit card market were transparent and price-competitive. These data demonstrate that the credit card market simply is not. Professor Zywicki should have given real consideration to the possibility that the industry might not be price-competitive, instead of dismissing that possibility as “facially implausible and empirically doubtful” (Zywicki 2000, 44). Although Zywicki pointed to some indicators of a dynamic market—shifting market share, entrants and exists, a large number of small players—he ignored key signs that the industry was not price-competitive—complex, misleading pricing structures and prices that did not respond to changes in costs. These features of the credit card market had been pointed out by researchers such as Lawrence Ausubel as early as 1997 (Zywicki 2000, 33). Nevertheless, Professor Zywicki went so far as to conclude that “the credit card industry appears to be as close a representation to a perfectly competitive market as one could imagine” (Zywicki 2000, 69).

The results of this paper demonstrate why scholars who are serious about accurately predicting the impact of regulatory change must not assume that markets are price-competitive and instead must analyze each industry individually. The world is full of markets that are uncompetitive on price to varying degrees because uncompetitive markets are more profitable for producing firms than competitive markets. The creation of such highly profitable, uncompetitive environments (without running afoul of regulators) is therefore often the goal of corporate strategy, sales, marketing, and legal departments. Failure to consider the implications of uncompetitive markets is a severe analytical flaw. It calls into question both the predictive value of theoretical economic analysis and the purported objectivity with which it is conducted. On the other hand, robust

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empirical analysis, independent of any ideological assumptions, can lead to better scholarship and better policy.
Reference List


Nilson Report


Weston, Liz P. “Zombie Debt is Hard to Kill.” _MSN Money._ Available at [http://articles.moneycentral.msn.com/SavingandDebt/ManageDebt/ZombieDebtIsHardToKill.aspx](http://articles.moneycentral.msn.com/SavingandDebt/ManageDebt/ZombieDebtIsHardToKill.aspx)


Also cited as “The Economics of Credit Cards.” 3 Chapman Law Review 79 (2000) [note: page number citations of this article refer to the SSRN working paper, not the Chapman article].

United States Government Accountability Office. 2006. “Credit Cards: Increased Complexity in rates and fees heightens need for more effective disclosures to consumers.”
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# Table 1: Credit Card Loss Rates and Personal Bankruptcy Filings

## Table 1: Credit Card Loss Rates and Personal Bankruptcy Filings

<table>
<thead>
<tr>
<th>Report Date</th>
<th>Net credit card charge-off rates, %</th>
<th>Personal Bankruptcy Filing, Thousands</th>
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Source: FDIC Quarterly Banking Profile, Administrative Offices of the United States Courts

December 2007 bankruptcy filings are not yet available
Figure 1: Bankruptcy filings and credit card loss rates declined
Figure 2: Credit card lenders’ charge-offs declined in 2006, but climbed in 2007

Source: FDIC Quarterly Banking Profile, December 2007 report
Figure 3: Late payment and over-limit fees have increased
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Source: CardWeb CardData
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Source: Cardweb
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