

Costs of Defaulting on Credit Card Debt Depend on the “Exit” Taken by Borrower

By Juan M. Sánchez

Households use credit cards to finance their purchases of goods and to pay for unexpected expenditures. Sometimes, their economic conditions deteriorate, and they are not able to honor their debt—not even make the minimum payment. In those situations, they have two options: (1) skip a payment and become delinquent on credit card debt or (2) file for Chapter 7 bankruptcy and discharge those obligations. Options 1 and 2 are usually referred to as informal and formal default, respectively.

Perhaps the most important difference between formal and informal default is in terms of the “benefits.” Households that file for bankruptcy are able to write off their debts, but there is uncertainty about what happens to the debt of households in delinquency.

Before filing for bankruptcy, households typically go through delinquency for 30 to 120 days. However, at least some households are able to pay their debts and avoid bankruptcy after delinquency. A recent study shows that of those who were in delinquency during 2001, two years later 17.5 percent were in bankruptcy, 65.7 percent continued in informal default and the rest showed some improvement in their credit situations.¹

With both options, the credit score deteriorates dramatically. But there are other

costs associated with these two options—costs that differ between the options. During delinquency, and depending on the state, debt collectors can garnish typically up to 25 percent of wages. Many states have limitations to stop lawsuits from collecting on a debt after some time, typically between three and six years. Bankruptcy stops wage garnishment immediately, but the household must have some resources to pay fees and sometimes hire a lawyer. Those costs typically exceed \$1,000.²

Perhaps the most important difference between formal and informal default is in terms of the “benefits.” Households that file for bankruptcy are able to write off their debts, but there is uncertainty about what happens to the debt of households in delinquency. Most credit card contracts have a penalty rate; so, the debt of households in delinquency may increase according to that rate. But households are often able to renegotiate that debt with lenders. There is not much information about what happens in those situations.

Typically, after the debtor has been delinquent for some time, the bank must “charge off” the credit card debt to comply with federal banking regulations. The proceeds from the sale can be counted as assets for capital requirements. That debt is sold to third-party collection agencies to be sold and resold to buyers of distressed debt. The price of that delinquent debt may be useful to estimate how much collectors expect to recover.

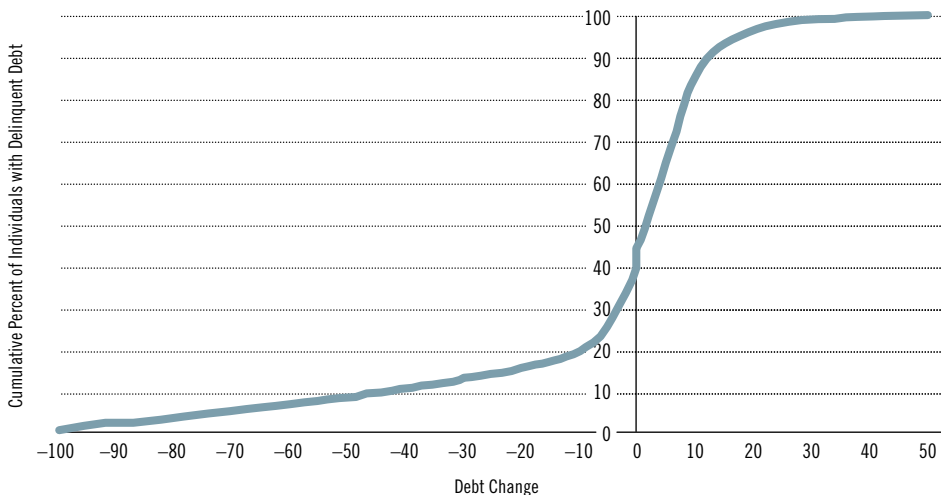
A recent study by the Federal Trade Commission (FTC) reports information on those transactions.³ The FTC analyzed 3,399 portfolios of debts that have been charged off. In those, 68 percent of the debt was less

than 3 years old, 71.5 percent was of less than \$1,000 and about 50 percent previously was sent to a collector. The study found that, on average, the price was 4 cents per \$1 of debt. This means that when collectors buy \$100 in debt from a bank, they pay only \$4. Why? The main reason is that they do not expect to recover \$100.

The price of the debt depends on its characteristics, such as size and age; debt that is very old or very high is more difficult to get paid back. The price per \$1 is higher, 7.9 cents, for what the FTC study considers as “baseline debt.” The baseline is credit card debt that is less than 3 years old, acquired from the original creditor, with a face value less than \$1,000 and that had never been sent to a contingency collector. For debt between \$5,000 and \$20,000, the price is 2 cents cheaper. The price for debt that is 15 years old is near zero because it is almost impossible to be recovered. There is a large heterogeneity on what happens to the debt of households that choose informal default. It’s unclear what happens to those households in the short run. Debt appears in the FTC study if it is sold to debt collectors, and that occurs only if the debt is “charged off,” which typically happens for credit card debts when they become 180 days past due.

We are able, however, to tell what happens in the shorter run with debt in delinquency by using data from Equifax. The dataset contains quarterly information about individuals’ debt and its status. For instance, it says how much debt an individual has, how many accounts and how many of them are 60+ days delinquent. Since the data are a panel, we can follow an individual and compute how much the debt changes between

Cumulative Distribution of Changes in Debt for Those in Delinquency




SOURCES: Federal Reserve Bank of New York Credit Panel/Equifax.

NOTE: Change of debt from the first quarter 2004 to the second quarter 2004, using the amounts of debt in the first quarter of 2004 as weights. Delinquency is defined as all credit card accounts in 90+ days' delinquency in the first quarter of 2004.

two consecutive quarters. In particular, we consider the variable “debt change,” defined as the change in debt among those who have all of their accounts delinquent for 90 days or more in the initial quarter. The chart shows that there is a large dispersion in the values of debt changes. The line represents, for a given value in the debt change (*x-axis*), the cumulative percent of individuals with debt change smaller or equal than that given value.⁴ This chart shows that for about 40 percent of the households that were in delinquency, their debt change is negative (i.e., the blue line crosses the *y-axis* at about 40 percent). Actually, for many of them, it decreased significantly. For instance, for about 15 percent of the individuals in delinquency, debt decreased more than 25 percent from one quarter to the next. Debt also increased for many individuals; for about 15 percent of individuals initially in delinquency, their debt increased more than 10 percent. This heterogeneity is hard to reconcile with the idea that all of these individuals are charged the same penalty rate, since in that case there should be only one bar. In contrast, the findings here are more in line with the idea that households get a deal that is related to their repayment capacity.

Research at the Federal Reserve Bank of St. Louis has led to a model in which households choose between formal and informal default over their life cycles.⁵ In the model, lenders choose how to change the face value

of the debt of households in delinquency to maximize the expected repayment of that debt. That process takes into account the households' characteristics. Lenders charge higher penalty rates to richer households in delinquency and lower rates to poorer households. Why? If lenders would charge high penalty rates to poorer households, the latter would be forced to file for bankruptcy, and the lender would recover nothing. This research shows that the model is able to account for salient features of the data. More important, this model can be used as a laboratory for policy analysis. 

Juan M. Sánchez is an economist at the Federal Reserve Bank of St. Louis. For more on his work, see <http://research.stlouisfed.org/econ/sanchez>.

ENDNOTES

- 1 See Drozd and Serrano-Padial.
- 2 See Hynes for a better description of bankruptcy filing costs.
- 3 See Federal Trade Commission.
- 4 For plot purposes, we restrict attention to those whose changes of debt lie in between 1 (–100 percent) and 99 (+50 percent) percentiles of the original distribution.
- 5 See Athreya et al.

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