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Personal Bankruptcy and Financial Stability

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Federal Reserve Board Division of Financial Stability | Washington, D.C.

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Personal Bankruptcy and Financial Stability

Andreas Lehnert*

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The views expressed here are mine and not those of the Federal Reserve

Personal bankruptcy and financial stability

- Two very American phenomena
  1. "Fresh start" approach to personal bankruptcy
  2. Banking panics that cause severe economic damage (19th century)
- Causation could go in both directions
  - Fresh start → more borrowing/higher losses → financial crises
  - Financial crises → widespread economic hardship → desire for fresh start
- Evidence supports view that…
  - … fresh start is an important factor in willingness to borrow & lend
  - .. the amount of debt in the economy is associated with financial fragility

Outline

- A brief history lesson
- What is financial stability?
- How does personal bankruptcy affect financial resilience?
- Conclusion

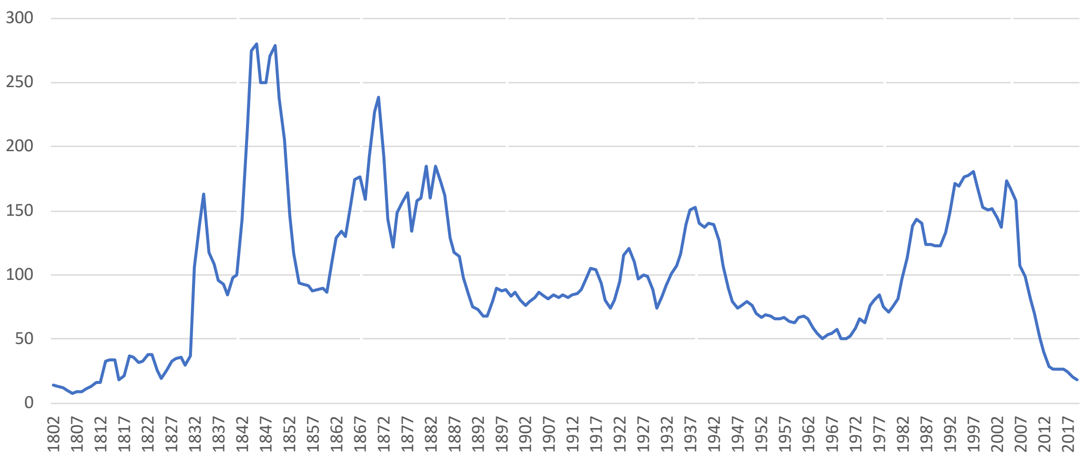
A brief history lesson

Panics and "fresh start" bankruptcy

Panic, as a health officer, sweeping the garbage out of Wall Street. Library of Congress LC-DIG-ds-04513
https://www.loc.gov/resource/ds.04513

- In the 19th century the United States was beset by periodic banking panics (seen to the left, from 1873, "sweeping the garbage out of Wall Street.")
- National panics every ~15 years: 1819, 1837, 1857, 1873, 1893, and 1907. Panic of 1907 led to the creation of the Federal Reserve in 1913.
- Also led to interest in a "fresh start" approach to distressed borrowers.

Term "bankruptcy" appears in books, by publication year, 1800—2019, (average=100)



Google Ngram, version 3, all forms/capitalizations of "bankruptcy" divided by total 1-grams per year, normalized so sample average=100.

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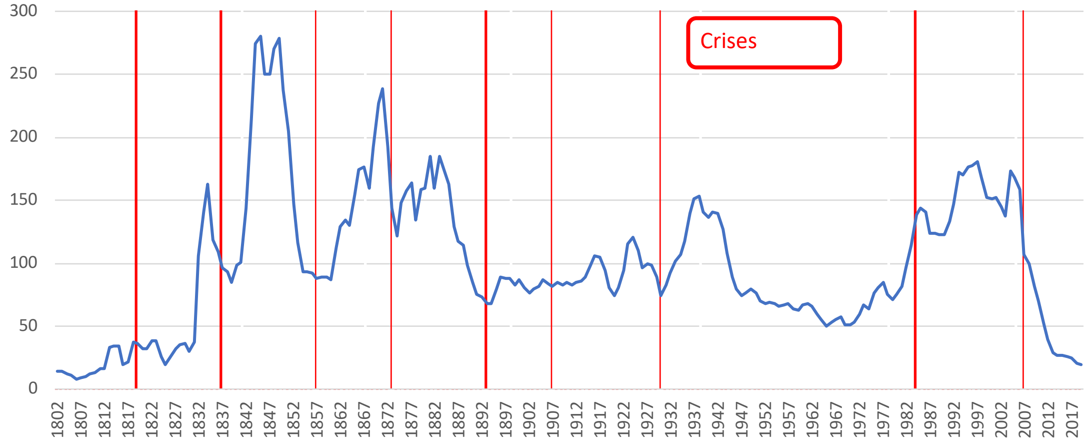

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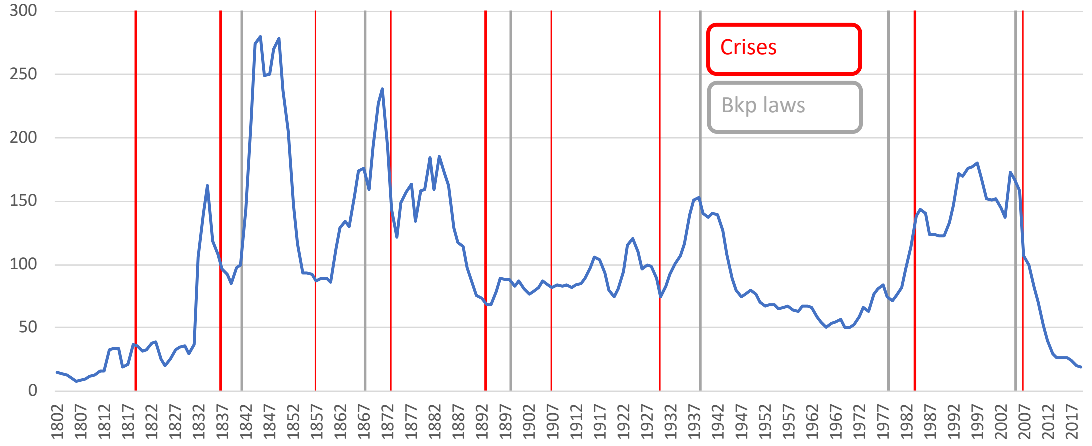

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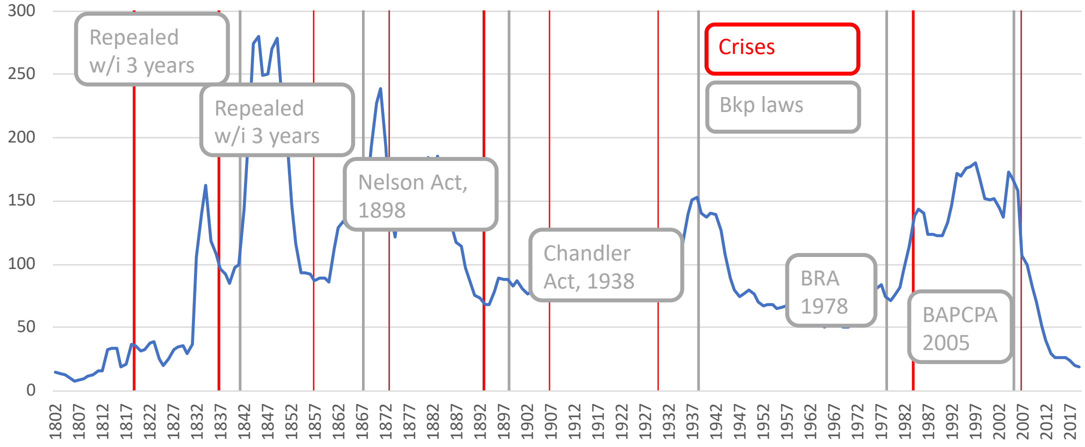


What is financial stability?

What is financial stability?

The financial system is stable when it is able to withstand a negative shock and continue to function

- Not about eliminating risk from the system
- A stable system does not make a bad shock worse
- Asset price declines, market volatility, etc. are not "financial instability"

Question: What makes a financial system fragile?

Financial crises

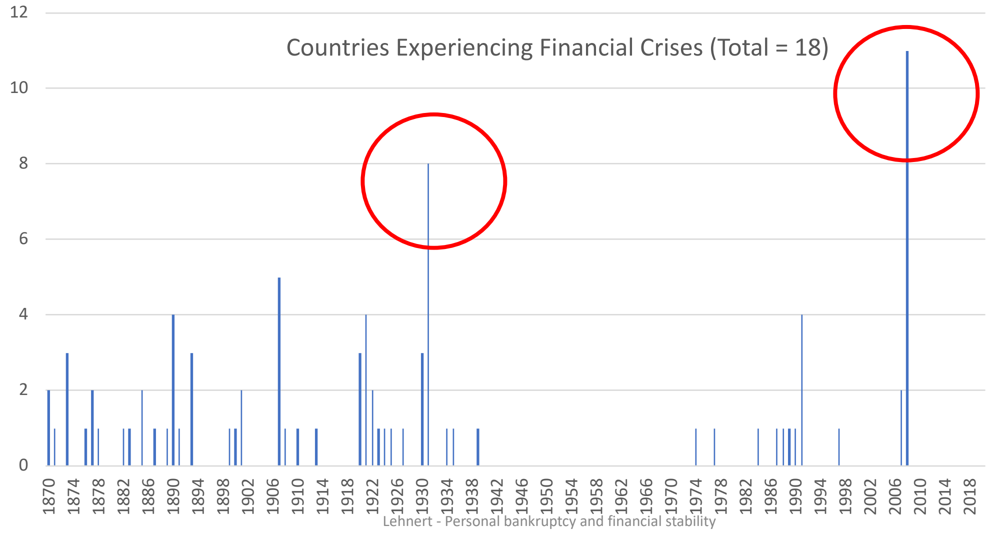
What is a financial crisis?

- Period of panic, bank runs, and excess defaults
- The financial system is unable to function normally after a bad shock
- Governments often intervene – bailouts, bank holidays, emergency lending, etc.
- Associated recessions are deeper (more "violent") than normal

Financial crises are rare

- Every crisis has a different cause, but pre-crisis periods have some similar features
- Have to look deep into history
- Use cross-country data over long period
  - Oscar Jorda, Moritz Schularick, Alan M. Taylor Macrohistory Database. Comparable data on key macroeconomic and financial variables for 18 countries from 1870 – 2019. http://www.macrohistory.net/data

Financial Crises, 18 Countries, 1870 - 2020



Financial crises are severe recessions

Real per-capita GDP growth, percent
Relative to each country's average growth in sample

Percentile	Normal years	Crisis years
10	-4	-7
25	-1	-4
50	0	-1
75	2	1
90	5	3

The 1-in-4 bad outcome for growth is:
- 1 percentage point below average in normal times
- 4 percentage points below average in a crisis

What predicts financial crises?

- Credit booms
  - Loans to households higher than average for multiple years
- Asset price booms
  - Equity and/or house price growth higher than average for multiple years
- Current account deficits
  - Imports less exports higher than average for multiple years

➢ *None of these give very strong signals; optimal combination still gives plenty of type I and type II errors. [Kiley (2018)]*

➢ *The Basel Committee on Bank Supervision recommended using the debt-to-GDP ratio as a guide. [Basel Committee (2010)]*

Household credit-to-GDP ratio

Fed's financial stability monitoring framework

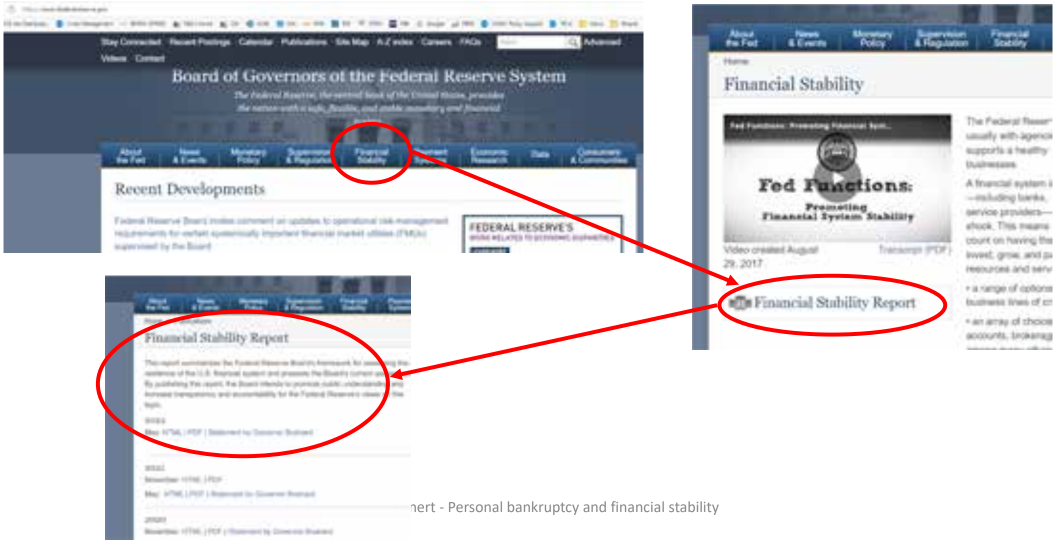
Distinguish between *shocks* and *vulnerabilities*

Track four main vulnerabilities

1. Asset valuations
2. Debt owed by households and businesses
3. Leverage of financial institutions
4. Funding risk of financial institutions and markets

Key indicators summarized in the Fed's *Financial Stability Report,* published twice/year (May and November).

Fed’s financial stability monitoring framework



How does personal bankruptcy affect financial resilience?

The economics of personal bankruptcy

- Standard model embeds decision to file for bankruptcy in a lifecycle model of consumption & savings
- Households face uncertainty about income and expenditure needs (e.g. uninsured medical expenses)
- Lenders understand household decision problem and set interest rates so as not to lose money in expected value

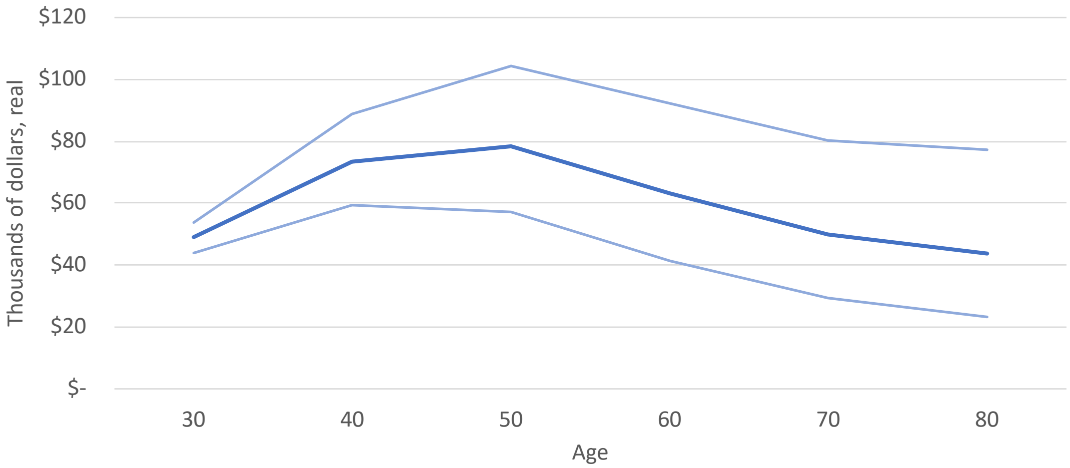
➢ *No role for bankruptcy law to promote unsustainable credit boom*

The lifecycle model

At each point along lifecycle (aka "age")…

- Individuals face:
  - Expected income, which is "hump shaped"
  - Shocks: job loss, illness-related income loss, unexpected bonuses, etc
  - Required expenditures – medical expenses etc
- Joint decision: file for bankruptcy; spend, save, and borrow
- Models predict
  - Consumption flatter than income – smoothing
  - Assets, debts, and bankruptcy all "hump shaped" too

Lifecycle income (example)



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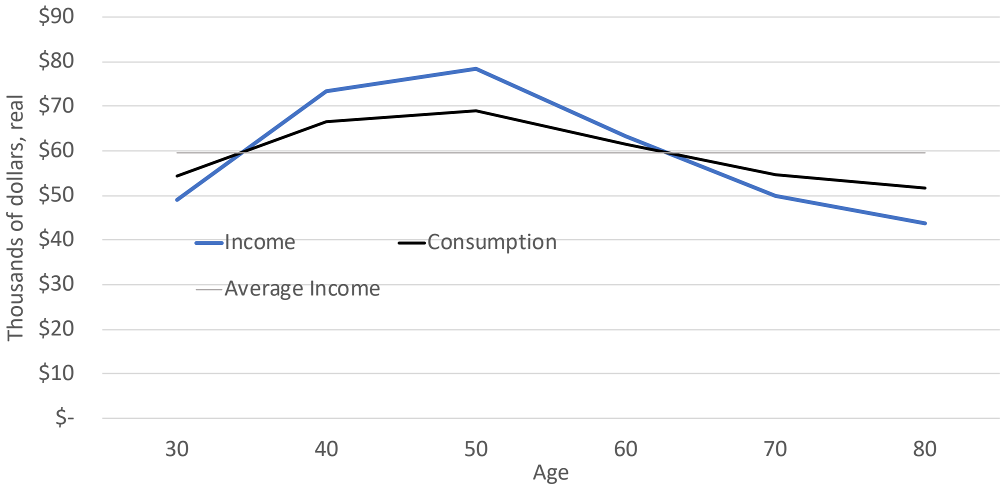
Lifecycle income and consumption (example)



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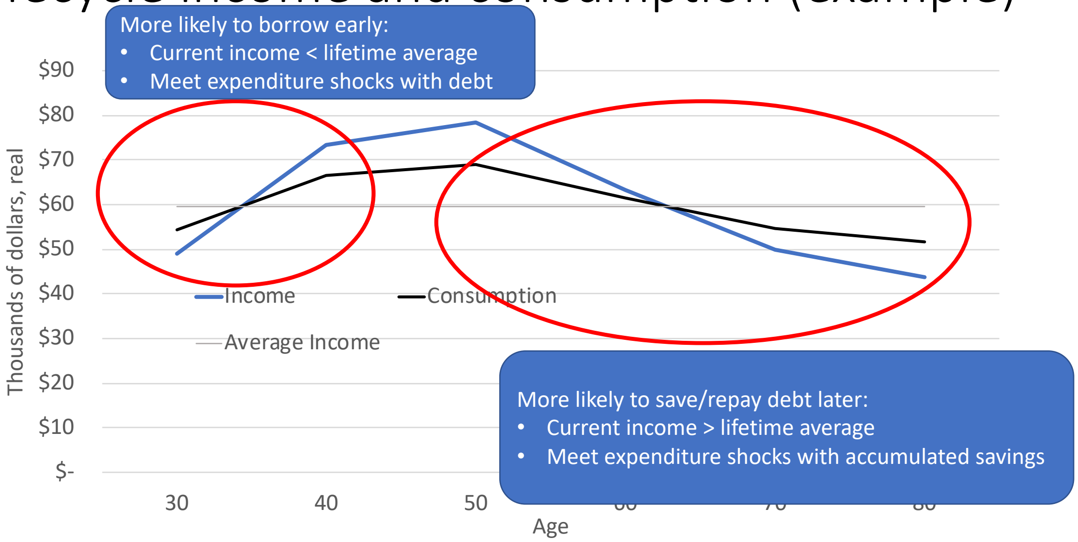
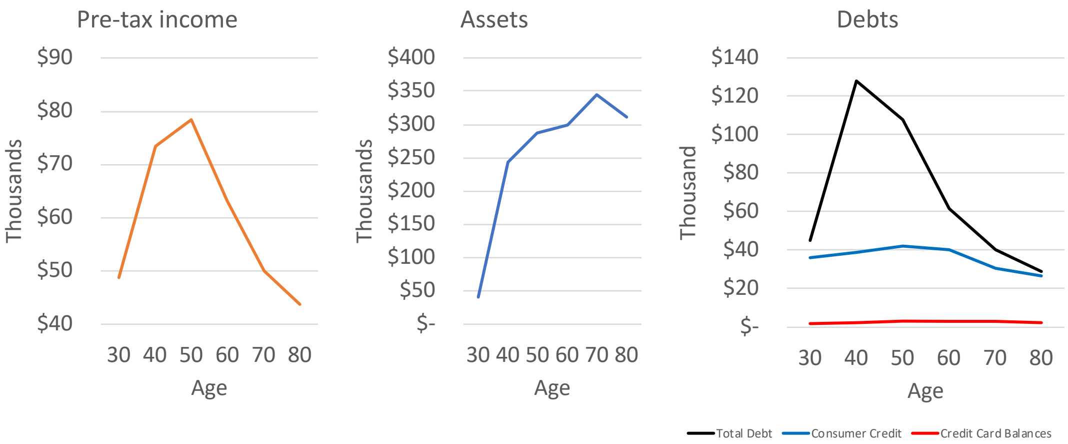
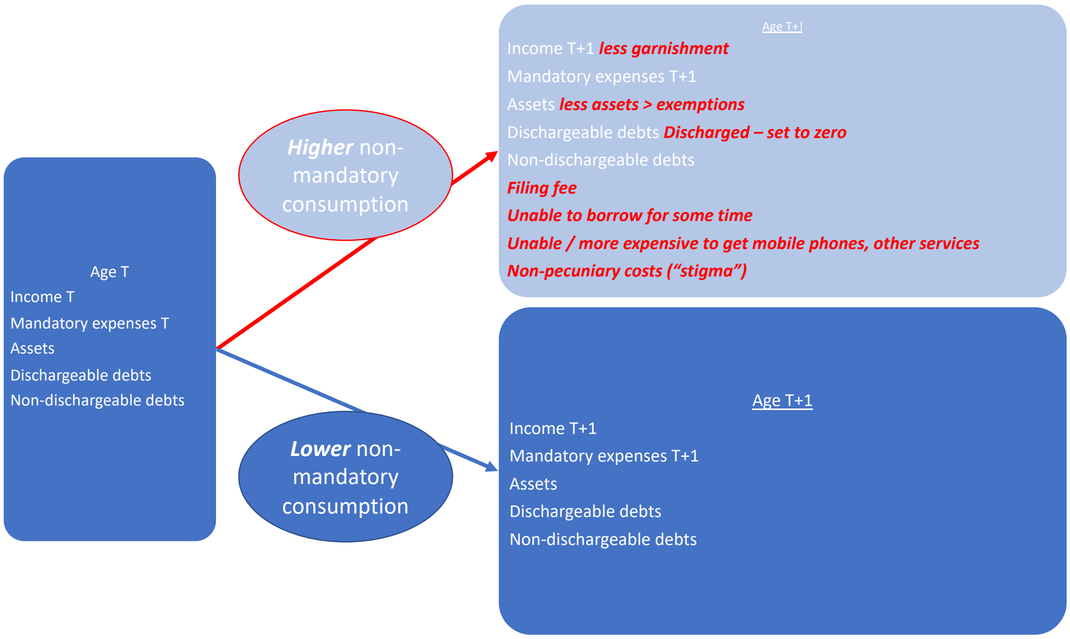
Lifecycle income and consumption (example)

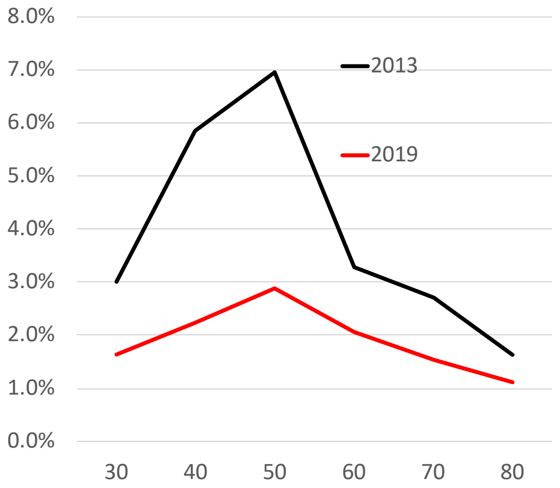


Median household income, assets, and debt over the lifecycle (2019 data)





Percent filing for bankruptcy in past 5 years



- Debt owed peaks between ages 35 – 45
- Bankruptcy filings peak between ages 45 – 55

- Consistent with lifecycle view
  - Income/expenditure shocks realized in first stages of lifecycle
  - Use debt to smooth consumption
  - Fraction of households seek fresh start

- Aggregate conditions really matter!
  - In 2013 (vs. 2019), the five-year lookback period included the Great Recession
  - In 2013 (vs. 2019), 2-3 *times* as many households had filed for bankruptcy over previous five years, for each age range

Personal bankruptcy and debt

- Fresh start personal bankruptcy
  - Households are more willing to borrow, *ceteris paribus*, but…
  - Lenders require higher interest rates or other security
- Evidence suggests
  - Households borrow early in life to smooth consumption
  - Households borrow in the face of expenditure/income shocks
- Households carrying unusually high debt loads…
  - …have experienced unusually bad income/expenditure shocks
  - …are more vulnerable to further bad shocks
- Standard lifecycle model does a good job of explaining household levels of debt and savings as well as bankruptcy
- No evidence that generous bankruptcy laws stimulated excessive borrowing

Conclusion

Conclusions

- Debt owed by households is a *weak* predictor of financial crises
  - Intuitively sensible: credit booms associated with self-fulfilling asset price/lending spirals that can end badly
- Financial crises are *strong* predictors of bankruptcy and public support for fresh starts
  - Financial crises are severe, widespread shocks to income – expect to see high delinquency/bankruptcy rates
  - Led to public support for fresh start bankruptcy laws in the 19th century
- Fresh start bankruptcy laws are important features of credit markets
  - But not the most important – income growth & risk more important

Questions?

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Faculty

Andreas Lehnert is the director of the Division of Financial Stability at the Federal Reserve Board in Washington, D.C., and his research focuses on financial stability, macroprudential policy, banking, and finance. He started in the Fed's household finance research group, where he worked on a variety of topics in consumer and mortgage credit. During the financial crisis, Mr. Lehnert contributed to several projects, including various mortgage-modification initiatives, the TARP, the 2009 bank stress tests and the TALF. In November 2010, he moved to the Fed's newly created financial stability group, and in December 2016 he was appointed director. The division oversees the Fed's periodic assessment of financial stability, including publishing the *Financial Stability Report* twice per year; supports policymaking to enhance financial stability, including the countercyclical capital buffer and the scenarios used in the Fed's periodic stress tests; and manages the Fed's staff response to stress events, including the set of 13(3) facilities deployed following the March 2020 onset of the pandemic. Mr. Lehnert participates in a variety of ongoing initiatives to promote financial stability, including regulatory reform, the periodic assessment of financial vulnerabilities, the development of macroprudential tools, and the design and oversight of the bank stress tests. In addition, he supports the Federal Reserve's role on the Financial Stability Oversight Council and the Financial Stability Board. Mr. Lehnert received his Ph.D. in economics from the University of Chicago.