Personal Bankruptcy Reform, Credit Availability, and Financial Distress

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Whether improving access to credit alleviates financial distress among households is the subject of intense debate. While it can mitigate financial hardship through the possibility of consumption smoothing, credit access may exacerbate distress among certain group of borrowers because of over-borrowing. Using the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), I investigate the impact of consumer credit availability on households' borrowing decisions and the subsequent effect on their financial well-being. Exploiting arguably exogenous cross-state variation in the generosity of bankruptcy law (exemption limits) prior to the Act, I find that households' access to credit increased significantly more in states with higher exemption limits, where lenders were more exposed to losses from bankruptcy filings. Households with low education and those with self-reported self-control problems responded aggressively by taking on large amounts of debt and spending it mainly on apparel and recreational activities. Consequently, households' distress, as measured by their inability to repay mortgage loans as well as a significant decline of food consumption, increased substantially more among low educated households and those with self-control problems. The paper highlights the real cost of credit availability for a subgroup of vulnerable borrowers.