Information and Credit Access:
Using Bankruptcy as a Signal

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Abstract

Legally, a bankruptcy flag can appear on an individual’s credit report for up to ten years after the filing. The flag affects an individual’s credit score, and in turn, an individual’s access to credit. In this paper, we investigate how the presence and subsequent removal of the bankruptcy flag affects access to credit along three dimensions—loan acceptance, the price of the loan as is determined by the interest rate, and the amount of credit the household receives.

Using the Panel Study of Income Dynamics (PSID) and the Survey of Consumer Finances (SCF), we estimate a series of two-stage models corrected for sample selection. We find that the bankruptcy flag increases the probability of being denied access to a loan, with the flag more than doubling the probability of being denied access to a loan. The flag also increases interest rates for both secured and unsecured loans, increasing the interest paid by 40 percent for automobile loans and by 11 percent for credit cards. For the credit limit, the results suggest that the bankruptcy flag lowers the credit card limit by 89 percent.

Additionally, when the flag is removed from the credit report, we continue to observe a decrease in access to credit, suggesting that the costs of filing for bankruptcy may be more long-term than previously expected. The findings have important implications with respect to current bankruptcy code and the impact that information, such as the bankruptcy flag, can have on the efficiency of the credit markets.

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